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Volume 7, Number 1

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Hyperinflation and Hyperreality: Thomas Mann in Light of Austrian Economics

Paul A. Cantor*

> One may say that, apart from wars and revolutions, there is nothing in our modern civilizations which compares in importance to [inflation]. The upheavals caused by inflations are so profound that people prefer to hush them up and conceal them.
>
> —Elias Canetti, *Crowds and Power*

I

With the worldwide collapse of socialism as an economic system, Marxism today stands thoroughly discredited as an intellectual position. Made prophetically early in this century, Ludwig von Mises's claim that economic calculation is impossible in the absence of free markets has been vindicated by the manifest failure of Soviet communism. Decisively refuted by the facts of economic life, Marxism has been forced to retreat to the one place in the academy where empirical reality seems to carry no weight in an argument: the humanities departments. As has often been noted, the great paradox of academic life at the moment is that just when Marxism has lost all credibility in the practical world, it has come to dominate the study of the humanities in American universities. Deconstruction and other forms of poststructuralism prepared the way for this outcome. By calling into question any notion of truth and objectivity, these movements in literary theory left humanities departments vulnerable to the lingering bewitchment of Marxism in a way to which other disciplines more in touch with reality have been comparatively immune.

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In the grand sweep of world history, it may seem a fair exchange to see millions of people liberated from the Marxism that was forced upon them, while a handful of literature professors voluntarily subject themselves to an outmoded and refuted dogma that somehow flatters their egos and soothes their social consciences. And despite the grandiose claims of literary critics to be changing the world, no one—not even a Chairman of the Federal Reserve—has ever been foolish enough to turn to a professor of English for economic advice. Thus one might be tempted to accept the apparently benign use of American humanities departments as retirement homes for washed-up Marxists. But we should not underestimate the danger of abandoning the study of literature to Marxist theorists; how our students view the humanities may well affect their broader view of the world. And in particular we need to guard against the possibility that Marxism may be repackaged under such slogans as "socialism with a human face." Having lost all respectability as an economic theory, Marxism is likely to continue to resurface periodically as a vaguely humanistic program. In a recent article, Richard Rorty forthrightly and courageously admits the economic failure of Marxism, and yet he cannot help looking back nostalgically to the days when socialism seemed to be a viable economic alternative:

> But I have to admit that something very important has been lost now that we can no longer see ourselves as fighting against "the capitalist system." For better or worse, "socialism" was a word that lifted the hearts of the best people who lived in our century. A lot of very brave men and women died for that word. They died for an idea that turned out not to work, but they nevertheless embodied virtues to which most of us can hardly aspire.[1]

Setting aside the fact that a lot of equally brave men and women died fighting *against* socialism, we can see in Rorty's statement the danger of allowing socialism to retain its claims to the moral high ground. One way of salvaging the cause of socialism is to insist that, however much a failure it may have been as an economic alternative to capitalism, it still provides a kind of ethical alternative in some vaguely humanistic sense.

At the heart of the form of deconstructed or aestheticized Marxism that currently dominates humanities departments stands the belief that literature with its higher ethical sense somehow still points us in the direction of socialism. But there is no reason why the

[1]Richard Rorty, "For a More Banal Politics," *Harper's Magazine*, May 1992, p. 18.

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left should have a monopoly on the study of literature. Even though many authors have in fact been socialist in their leanings, the prevailing notion that literature can only be used for leftwing purposes is just a myth. In a brief paper, I cannot hope to demolish systematically such a long-standing and ingrained prejudice. But I do want to use one concrete example to suggest that literary analysis need not be the exclusive preserve of the academic left, but is in fact compatible with Austrian economics. I will discuss a short story Thomas Mann wrote in 1925, "Unordnung und frühes Leid," or, as it is known in English, "Disorder and Early Sorrow."[2]

Set in Weimar Germany during the time of the hyperinflation, this story takes on new meaning once it is analyzed in terms of Mises's theory of inflation and the crack-up boom. With Mann's uncanny ability to mirror economic and social reality in his fiction, he succeeds even without any knowledge of Austrian economics in bringing out the psychological ramifications of an inflationary environment with a subtlety of insight Mises would have admired. Moreover, as we analyze "Disorder and Early Sorrow" in light of Mises's theory of inflation, we will see that the story has larger implications for our view of twentieth-century cultural history. A reading of Mann in terms of Austrian theory helps to uncover a connection between the economic facts of the twentieth century and the very poststructuralist ideas that have given Marxism a second life in today's humanities departments. In short, I hope to show that, despite all indications to the contrary from my colleagues, it is possible to talk about literature and still make economic sense.

II

At first sight, "Disorder and Early Sorrow" may appear too insubstantial a story to bear up under the weight of any kind of sustained analysis.[3] Mann tells the tale of an apparently average day in the

[2]I quote "Disorder and Early Sorrow" in the translation of H. T. Lowe-Porter, from Thomas Mann, *Death in Venice and Seven Other Stories* (New York: Vintage, 1989). When referring to the German original, I quote from Thomas Mann, *Gesammelte Werke* 13 vols. (Frankfurt: S. Fischer, 1974), vol. 8. Lowe-Porter's translation is filled with minor errors, omissions, and additions, which I have not bothered to correct, except where they have a bearing on interpreting Mann's intentions.

[3]Although "Disorder and Early Sorrow," is frequently referred to as a novella, and has many of the characteristics of the form, it seems to me brief enough to be properly called a short story. As for its seeming lack of substance, Henry Hatfield, for example, rather patronizingly says that the story "is one of Mann's less ambitious pieces, yet within its limits one of his most successful." See Henry Hatfield, *Thomas Mann* (Norfolk, Conn.: New Directions, 1951), p. 87. Although "Disorder and Early Sorrow" has been popular with readers, and is frequently anthologized, it has attracted little attention from critics. Few essays have been devoted to it specifically, and most general

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life of Dr. Abel Cornelius, a professor of history. His teenage children, Ingrid and Bert, are holding a party for their friends, a typical cross section of youthful acquaintances, including students and entertainers. Everyone enjoys the party, especially the professor's younger children, Ellie and Snapper, who relish the opportunity to spend time with the grownups. Finding his routine disturbed by the presence of all the young people, the professor is nevertheless in some ways attracted to them and their modern way of life. He wanders in and out of the party, tries to get some work done in his study, and eventually goes out for his daily walk. He returns to find his house in an uproar. His five-year old daughter is throwing a tantrum, as a result of feeling spurned by an engineering student named Max Hergesell, for whom she rather precociously developed a crush while he playfully danced with her. Upset that Hergesell cannot be her brother, little Ellie is not consoled until Max gallantly comes to her room to wish her good night, thus bringing the tale to a close with a poignant hope of innocence restored.

Though seemingly slim in substance, "Disorder and Early Sorrow" presents the kind of world familiar to us from the great texts of literary modernism, such as Eliot's *The Waste Land* or Mann's own "Death in Venice." The story charts the dissolution of authority, as we watch a social order breaking down and see the confusions that result. In particular, Mann portrays a world in which parents are losing their authority over their children. Obviously viewing their parents as old fogies, the children think of their generation as smarter than the preceding one. Mann portrays a world that has gone mad in the worship of youth. As a sign of the resulting confusion, we are introduced to the "big folk" (*die Grossen*) in the first paragraph (p. 179), only to discover in the second that the term applies to the teenagers, not, as one would expect, to their parents. The little children already call their father by his first name. As a story of people growing up too fast, "Disorder and Early Sorrow" appropriately concludes with the incident of Ellie's infatuation with Max. The image of a five-year old girl having her first love affair becomes Mann's way of crystallizing

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studies of Mann mention it only in passing. If they discuss it at all, critics usually choose to concentrate on the autobiographical aspects of the story. Evidently Mann based the story largely on a party actually given in his own household in Munich. See the account of his son: Michael Mann, "Truth and Poetry in Thomas Mann's Work" in *Thomas Mann*, Harold Bloom, ed. (New York: Chelsea House, 1986), pp. 292–93. Some critics discuss the Freudian implications of the relationship between the father and the daughter in the story. Herbert Lehnert develops a brief but interesting interpretation of the story as involving an inversion of the structure of *The Magic Mountain*; see *Thomas Mann: Fiktion, Mythos, Religion*, 2nd ed. (Stuttgart: W. Kohlhammer, 1968), p. 97.

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our sense of the absurd pace of development in this world.

In "Disorder and Early Sorrow" all categories are breaking down. While the children behave like adults, the adults start behaving like children; in order to play with Ellie and Snapper, Cornelius "will crook his knees until he is the same height with themselves and go walking with them, hand in hand" (p. 191). This image of a "diminished Abel" (p. 191) points to the broader collapse of hierarchy in Cornelius's world, especially any sense of social distinctions. He has a hard time telling his son from his servant; they dress alike and are prone to the same youthful fads and fashions (pp. 179–80, 203). The world of "Disorder and Early Sorrow" has become so confusing that it is difficult for the characters simply to tell what is real anymore. This aspect is brought out by the presence of actors throughout the story. Mann emphasizes elements of imitation and parody; Ingrid has "a marked and irresistible talent for burlesque" (p. 179), which she and her brother love to put to use:

> They adore impersonating fictitious characters; they love to sit in a bus and carry on long lifelike conversations in a dialect which they otherwise never speak. (p. 183)

When an actor named Ivan Herzl shows up at the party in heavy makeup, he provokes Cornelius into thinking about how people no longer are what they seem: "You would think a man would be one thing or the other—not melancholic and use face paint at the same time" (p. 196). Mann creates a pervasive sense of inauthenticity in the story; the modern world is a counterfeit world.

With all stable points of reference gone, the only law of "Disorder and Early Sorrow" appears to be perpetual change. Against this instability, Mann sets his central character. As a professor of history, Cornelius is always searching for something solid to grab hold of in the midst of all this mutability, and he wistfully contrasts the fixity of the past with the everchanging world of the present:

> He knows that history professors do not love history because it is something that comes to pass, but only because it is something that *has* come to pass; that they hate a revolution like the present one because they feel it is lawless, incoherent, irrelevant—in a word, unhistoric; that their hearts belong to the coherent, disciplined, historic past. . . . [He seeks] the temper of eternity. (p. 186)

Thus like *The Waste Land*, "Disorder and Early Sorrow" counterpoints the coherence of past eras with the incoherence of modern times.

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III

Thus far Mann's story sounds like many other modernist works, chronicling the breakdown of order in twentieth-century life. But when one looks in the story for Mann's sense of what is responsible for this breakdown, the uniqueness of "Disorder and Early Sorrow" begins to emerge. Modernists have put forward many explanations for the incoherence of twentieth-century life. In *The Waste Land*, for example, Eliot correlates the disorder of the modern city with a failure of religious faith and a loss of the traditional myths that used to give coherence to life. But in "Disorder and Early Sorrow," Mann explores another possibility, correlating his portrait of modern life with a specific historical event—the German inflation of the 1920s, an economic development so extraordinary that a new term had to be coined to describe it—*hyperinflation*. The absurdity of modern life has been traced to many sources, but here Mann looks to the absurdity of modern economic policies. He suggests that if we seek an explanation of the dissolution of authority in the world he is portraying, we should look to the monetary madness of the Weimar Republic.[4] As he shows, inflation eats away at more than people's pocketbooks; it fundamentally changes the way they view the world, ultimately weakening even their sense of reality. In short Mann suggests a connection between hyperinflation and what is often called hyperreality.[5]

[4]Though some critics acknowledge in passing the fact that "Disorder and Early Sorrow" is set in the time of the German inflation, it is surprising how little critics make of the importance of economic factors in the story. Hans Eichner, *Thomas Mann: Eine Einführung in Sein Werk* (München: Lehnen, 1953), p. 64, relates Ellie's tantrum to "die allgemeine Verwirrung der Inflationsjahre" ("the general confusion of the inflation years"), but says nothing further. The fullest discussion in English of the story I have been able to locate mentions inflation just once, and then as only one of many examples of disorder in the story. See Sidney Bolkovsky, "Thomas Mann's 'Disorder and Early Sorrow': The Writer as Social Critic," *Contemporary Literature* 22 (1981): 221. In a brief essay on the story, Mann himself stressed its personal and psychological elements, but he also expressed his satisfaction that it had appeared in French translation under the title "Au temps de l'inflation," which he says is in accord with the author's intention and meaning ("nach des Verfassers Absicht und Meinung"). He was happy that in foreign countries the story was being understood as "a document of middle-class German life after the war" ("als Dokument deutsch-bürgerlichen Nachkriegsleben"). See "Unordnung und frühes Leid," *Gesammelte Werke*, 11: 621. When Mann described the story in a letter, he called it: " 'Unordnung und frühes Leid,' eine Inflationsgeschichte" ("a history of inflation" or "an inflation story"). Letter to Hans Heinrich Borcherdt, March 3, 1926, as quoted in Esther H. Lesér, *Thomas Mann's Short Fiction: An Intellectual Biography* (Rutherford, N.J.: Fairleigh Dickinson University Press, 1989), p. 304, n. 50.

[5]The terms *hyperreality* and *hyperrealism* originated in art criticism. They refer to a style of painting so photographically realistic that it in fact makes the work look

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If modernity is characterized by a loss of the sense of the real, this fact is connected to what has happened to money in the twentieth century. Everything threatens to become unreal once money ceases to be real. I said that a strong sense of counterfeit reality prevails in "Disorder and Early Sorrow." That fact is ultimately to be traced to the biggest counterfeiter of them all—the government and its printing presses. Hyperinflation occurs when a government starts printing all the money it wants, that is to say, when the government becomes a counterfeiter. Inflation is that moment when as a result of government action the distinction between real money and fake money begins to dissolve. That is why inflation has such a corrosive effect on society. Money is one of the primary measures of value in any society, perhaps *the* primary one, the principal repository of value. As such, money is a central source of stability, continuity, and coherence in any community. Hence to tamper with the basic money supply is to tamper with a community's sense of value. By making money worthless, inflation threatens to undermine and dissolve all sense of value in a society.

Thus Mann suggests a connection between inflation and nihilism. Perhaps in no society has nihilism ever been as prevalent an attitude as it was in Weimar Germany; it was reflected in all the arts, and ultimately in politics. It would of course be wrong to view this nihilism as solely the product of an inflationary environment. Obviously Weimar Germany faced many other problems, some the legacy of World War I and the Treaty of Versailles, some the legacy of nineteenth-century German thinkers such as Nietzsche. But as Mann's story reminds us, we should not underestimate the role of inflation in creating the pervasive sense of nihilism in Weimar Germany. A glance at the back of an American dollar bill shows two phrases: "United States of America" and "In God We Trust." Somehow our money is connected with our political and even our religious beliefs. Shake a people's faith in their money, and you will shake their other faiths as well. This problem has become particularly acute in the twentieth century, because ours is the age of paper money, money

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unreal. The terms have been given a broader meaning in contemporary discourse by such writers as Jean Baudrillard, who sees the whole world we live in as hyperrealistic in its pervasive artificiality: "The unreal is no longer that of dream or of fantasy, . . . it is that of a *hallucinatory resemblance of the real with itself*"; *"It is reality itself today that is hyperrealist"* (italics in the original). See Jean Baudrillard, *Simulations*, Paul Foss, Paul Patton, and Philip Beitchman, trans. (New York: Semiotext[e], 1983), pp. 142, 147. For a more popular account of the contemporary idea of hyperrealism, see Umberto Eco, *Travels in Hyperreality*, William Weaver, trans. (New York: Harcourt Brace, 1986), pp. 3–58.

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that has to be taken on faith alone. That is why we have to put "In God We Trust" on the back of our dollars; nobody really trusts the Chairman of the Federal Reserve. In "Disorder and Early Sorrow," Mann invites us to consider what happens to our lives when we are forced to take our money purely on faith and that faith is betrayed by the government.

Unlike many economists and historians to this day, Mann is not mystified by the cause of inflation[6]; he makes it clear in the details of the story that what has gone haywire in Weimar Germany somehow involves the money supply. We cannot help noticing that something is wrong when we hear of Cornelius drinking a "watery eight-thousand-mark beer" (p. 184). And Mann is aware that government fiscal policies are the source of the trouble. It cannot be an accident that the historical subject Cornelius is studying is precisely the beginnings of modern central banking and deficit financing, and hence the origins of inflation as a tool of modern public policy:

> First he reads Macaulay on the origin of the English public debt at the end of the seventeenth century; then an article in a French periodical on the rapid increase in the Spanish debt towards the end of the sixteenth.[7] (p. 192)

Financial details chronicling the absurdity of hyperinflation are scattered throughout the story. Cornelius is making a million marks

[6]For example, in his influential and widely praised study, *Weimar Culture* (New York: Harper & Row, 1968), the historian Peter Gay typically mistakes the effects of inflation for the causes: in his view the Weimar inflation was "caused by a shortage of gold, adverse balance of payments, and the flight of capital" (p. 152); only later in his account does he even refer, and then merely in passing, to the government's "printing of money" (p. 154). For a recent historical account of Weimar Germany that confirms the Austrian theory of the inflation, see Stephen A. Schuker, *American "Reparations" to Germany, 1919–33: Implications for the Third-World Debt Crisis* (Princeton, N. J.: Princeton University Press, 1988), p. 20: "a budget deficit that could not be financed except through the issue of floating debt discounted by the Reichsbank represented the real engine of inflation."

[7]The relevant passage in Macaulay can be found in Chapter 19 of his *History of England*. See *The Works of Lord Macaulay* (London: Longmans Green, 1898), vol. 5, pp. 335–49. That Mann had recently been reading this section when he wrote "Disorder and Early Sorrow" is suggested by a verbal echo; at one point Macaulay speaks of "the lamp of Aladdin" (p. 346), while in the German Mann refers to "Aladin mit der Wunderlampe" (p. 646); the parallel seems weaker in the translation, where Lowe-Porter merely speaks of "Alladin" (p. 204). In this section of his history, Macaulay discusses the moment when the British Parliament created the national debt to deal with the budget deficits it had incurred, chiefly in financing wars. Mann undoubtedly saw the parallels to the situation in Germany after World War I. Macaulay praises deficit financing as a wonderful contrivance for national prosperity; Mann had less cause to be this sanguine about its effects.

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a month, and that is merely "more or less adequate to the chances and changes of post-war life" (p. 182).

Under these insane conditions, people become obsessed with the economic facts of life and must devote all their energy just to trying to stay above water. Frau Cornelius feels disoriented in the most basic tasks of daily life:

> The floor is always swaying under her feet, and everything seems upside down. She speaks of what is uppermost in her mind: the eggs, they simply must be bought today. Six thousand marks a piece they are, and just so many are to be had on this one day of the week at one single shop fifteen minutes' journey away. (p. 183)

We see here how one government intervention in the economy immediately leads to others. Having produced scarcities in the market with their inflationary policies, the authorities introduce new regulations to try to deal with the irrationality they themselves created. But faced with the rationing of goods, the people in Mann's story learn to get around the government's tampering with the market:

> For no single household is allowed more than five eggs a week; therefore the young people will enter the shop singly, one after another, under assumed names, and thus wring twenty eggs from the shopkeeper for the Cornelius family. (p. 183)

Here Mann presents the characteristic inauthenticity of the world he is portraying as a direct response to government intervention in the market, which forces people to become fakes.

Mann is aware of how absurd the German inflation became, and moreover he shows how that absurdity in turn worked to make all of life absurd in the Weimar Republic. He shows one of the moments in inflation Mises concentrated on, the flight into real goods:[8]

> Before the young people arrive [Frau Cornelius] has to take her shopping basket and dash into town on her bicycle, to turn into provisions a sum of money she has in hand, which she dares not keep lest it lose all value. (p. 192)

With the value of money diminishing virtually hour by hour, people desperately search for some way to hold on to value, and that means they rush to exchange their largely fictitious money for something real, a real good. Thus inflation serves to heighten the already frantic

[8]In German, "die Flucht in die Sachwerte"; see Ludwig von Mises, *Human Action* (New Haven, Conn.: Yale University Press, 1949), p. 424.

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pace of modern life, a pace that further disorients people and undermines whatever sense of stability they may still have.

Mann also shows how inflation disrupts the social order, producing as it does a huge underground transfer of wealth. Those people who had worked hard and put their money in the bank saw their savings become worthless almost overnight. Mann documents the fall of the middle class in the case of the Hinterhofers:

> two sisters once of the lower middle class who, in these evil days, are reduced to living "*au pair*" as the phrase goes and officiating as cook and housemaid for their board and keep. (p. 191)

Mann shows how hard it is for these women to live with their sense of economic degradation, portraying the shame and bitterness of Cecilia Hinterhofer:

> Her bearing is as self-assertive as usual, this being her way of sustaining her dignity as a former member of the middle class. For Fräulein Cecilia feels acutely her descent into the ranks of domestic service. . . . She hands the dishes with averted face and elevated nose—a fallen queen. (p. 202)

A society composed of embittered people like the Hinterhofers is soon going to face major political problems, as the rise of fascism in Germany was to show.

At the same time as many people lost everything during the German inflation, some made their fortunes by taking advantage of the new economic conditions. Mann includes among the cast of characters the kind of speculators who profited from inflation:

> They lead . . . that precarious and scrambling existence which is purely the product of the time. There is a tall, pale, spindling youth, the son of a dentist, who lives by speculation.[9] . . . He keeps a car, treats his friends to champagne suppers, and showers presents upon them on every occasion. (p. 204)

Those who know how to exploit an inflationary situation can gain as much as others lose. As a result, inflation creates a topsy-turvy world. The fact that people are losing and making fortunes overnight is responsible for all the social confusions in "Disorder and Early Sorrow," such as Cornelius's inability to tell his son from his servant. In a world in which all distinct categories begin to dissolve, a pervasive

[9]The German here is more specific—the character is a *Börsenspekulant*, a "stock market speculator" (p. 646).

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sense of relativism develops. Cornelius's convictions begin to weaken and he feels unable to take a stand against the opinions of the younger generation. In a frightening anticipation of today's tyranny of political correctness, the history professor retreats into an academic skepticism when faced with the fanaticism of youth, trying to make his lack of conviction masquerade as a form of broadmindedness:

> For in one's dealings with the young it behoves one to display the scientific spirit . . . in order not to wound them or indirectly offend their political sensibilities; particularly in these days, when there is so much tinder in the air, opinions are so frightfully split up and chaotic, and you may so easily incur attacks from one party or the other, or even give rise to scandal, by taking sides. (p. 207)

Worried about taking any sort of stand, Cornelius begins to question his most fundamental certainties: "And is there then no such thing as justice?" (p. 207). Mann thus shows how inflation ultimately has a political effect, eating away at the basic beliefs that give a grounding to social order. By undermining all sense of stability and value in Weimar Germany, inflation ultimately led to the rise of Hitler and Nazism.[10]

IV

Mann is as acute in portraying the psychological effects of inflation as he is in portraying the economic, social and political effects. As he shows, inflation fundamentally changes the way people think, forcing them to live for the moment. There is no use planning for the future, since inflation, especially hyperinflation, makes future conditions uncertain and unpredictable. As Mises demonstrated, the most insidious effect of inflation is that it makes economic calculation nearly impossible. It thereby destroys the Protestant ethic, which ever since Max Weber has been viewed as linked to capitalism. What is the use of saving one's money if that money will soon become worthless as a result of inflation? As Mann shows, in an inflationary environment, the rational strategy is to spend your money as fast as you make it. Thus inflation works to shorten everyone's time horizons, destroying

[10]It may seem extreme to blame the rise of Hitler on the German inflation, but for an insightful discussion of the connection between inflation and Nazism, see Elias Canetti, *Crowds and Power*, Carol Stewart, trans. (New York: Seabury, 1978), esp. pp. 187–88. Canetti even links the devaluation of human life represented by the Holocaust directly to the German inflation. For Mises's own frank account of Weimar politics, and the role of inflation in the rise of Nazism, see his *Omnipotent Government: The Rise of the Total State and Total War* (New Haven, Conn.: Yale University Press, 1944), pp. 193–228.

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precisely those attitudes and habits that normally make the middle class hard workers and prudent investors, those forces that lead them to restrict their present consumption for the sake of increasing future production.

This effect of inflation explains why youth has come to dominate the world of "Disorder and Early Sorrow," and why the older generation has lost its authority. The young are more adaptable to changing conditions, while the old are set in their ways. Hence the young cope better with inflation:

> the upper middle class . . . look odd enough . . . with their worn and turned clothing and altered way of life. The children, of course, know nothing else; to them it is normal and regular. . . . The problem of clothing troubles them not at all. They and their like have evolved a costume to fit the time, by poverty out of a taste for innovation: in summer it consists of scarcely more than a belted linen smock and sandals. The middle-class parents find things rather more difficult. (p. 182)

Mann notes that inflation even changes the way people dress, but, more importantly, he sees that it alters the dynamic between the generations in society, giving the young a huge advantage over the old. Not having experienced economic stability, the youth of Germany are more able to go with the inflationary flow.

In the person of Cornelius's servant, young Xaver, Mann portrays the perfect child of the inflationary era, the embodiment of its virtues and its vices:

> He is the child and product of the disrupted times, a perfect specimen of his generation. . . . The Professor's name for him is the "minute-man,"[11] because he is always to be counted on in any sudden crisis, . . . and will display therein amazing readiness and resource. But he utterly lacks a sense of duty and can as little be trained to the performance of the daily round and common task as some kinds of dog can be taught to jump over a stick. (pp. 202–3)

Xaver has the adaptability to changing conditions demanded by the era of inflation, but the price he pays for that is the total loss of the discipline once prized in German society. His lack of feeling for the past of course disturbs his master, the history professor, but as a child of inflation Xaver is constantly plunging into the future:

[11]Here the English translation is in some ways more appropriate than the original German. Mann has Cornelius speak of Xaver as *Festordner* (p. 645), "master of ceremonies," not "minute-man."

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> Dr. Cornelius has often told him to leave the calendar alone, for he tends to tear off two leaves at a time and thus to add to the general confusion. But young Xaver appears to find joy in this activity. (p. 203)

In a world in which the young are leaping into the future two days at a time, the old become increasingly irrelevant. Economists have long recognized that inflation is particularly cruel to the elderly in society, especially retired people who live on fixed incomes, which cannot keep pace with inflation. Mann fills in our sense of the psychological disruptions that accompany the economic ravages of inflation. More than any other factor, inflation discredits the authority of the older generation and turns power over to youth. It is not simply a matter of the old losing their economic advantage over the young. In an inflationary environment, all the normal virtues of the old suddenly start to work against them, while all the normal vices of the young suddenly seem to look like wisdom. Conservatism and a sense of tradition make it impossible to respond to rapidly changing economic conditions, while the profligacy of youth becomes paradoxically a kind of prudence in an inflationary environment. Mann's genius is to show how all the characteristics of the world in "Disorder and Early Sorrow" flow from the new economic facts of life. One still needs to turn to economists like Mises to understand the causes and the full economic ramifications of inflation. But what Mann does for us is to show the human reality of the phenomenon, how it alters not just economic conditions but the very fabric of everyday life, right down to the psyches of young children.[12] Ellie's premature infatuation with Max is the emotional equivalent of inflation.

[12]Mann was of course not the only writer of his day who portrayed the effects of inflation, though it is surprising how little attention literary critics have paid to this phenomenon. I have been able to locate only one brief article that deals with the depiction of the 1920s inflation in literature; appropriately it treats Austrian authors. See Friedrich Achberger, "Die Inflation und die zeitgenössische Literatur," in *Aufbruch und Untergang: Österreichische Kultur zwischen 1918 und 1938*, Franz Kadrnoska, ed. (Vienna: Europa, 1981), pp. 29–42. Achberger lists 33 Austrian literary works with the inflation as their theme, including works by such well-known authors as Heimito von Doderer, Robert Musil, and Stefan Zweig. From Achberger's descriptions, these works evidently have much in common with "Disorder and Early Sorrow." Achberger mentions that Mann's brother, Heinrich, also wrote a novella dealing with the inflation period called *Kobes* (1925); Hugo Stinnes, the German industrialist who profited heavily from the inflation, provides the model for this work. Rolf Linn remarks: "This makes 'Kobes' unique, for the vast literature about the turbulent post-war years in Germany—all but forgotten with the exception of Thomas Mann's 'Disorder and Early Sorrow'—deals largely with the victims of the rapid devaluation of the mark." See Rolf Linn, *Heinrich Mann* (New York: Twayne, 1967), p. 83.

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V

In addition to all its economic, social, political, and even psychological consequences, inflation in Mann's view works to undermine the basic sense of reality.[13] In the world of inflation, reality begins to attenuate. As we have seen, even an eight-thousand-mark beer is watered down. For a variety of reasons, prices cannot always be raised to keep pace with inflation; hence producers are forced to cheapen their products, to adulterate them. Mann portrays a pervasive cheapening of the world in "Disorder and Early Sorrow." Cornelius thinks of himself as a gentleman, but in his straitened circumstances, he cannot help cutting corners, even when offering cigarettes to his guests:

> He . . . takes a box from his supply in the cupboard: not the best ones, nor yet the brand he himself prefers, but a certain long, thin kind he is not averse to getting rid of—after all, they are nothing but youngsters. (p. 198)

Typically in this inflationary environment, things end up in a state of disrepair, as normal economic channels become disrupted:

> The basin has been out of repair for two years. It is supposed to tip, but has broken away from its socket on one side and cannot be mended because there is nobody to mend it; neither replaced because no shop can supply another. (p. 193)

Once one realizes what is going on in "Disorder and Early Sorrow," one can see how the opening of the story is emblematic of the world Mann is portraying:

[13]An interesting literary parallel can be found in the third part of Hermann Broch's trilogy *The Sleepwalkers*, Willa and Edwin Muir, trans. (New York: Grosset & Dunlap, 1964). His character Huguenau finds his world unhinged by the process of inflation: "Currency hitherto accepted becomes incalculable, standards fluctuate, and, in spite of all the explanations that can be adduced to account for the irrational, what is finite fails to keep pace with the infinite and no reasonable means avail to reduce the irrational uncertainty of the infinite to sense and reason again" (p. 640). Economics had represented the world of rationality to Huguenau, but inflation turns that rationality into irrationality: "even that most characteristic mode of the bourgeois existence, that partial system which is hardier than all others because it promises an unshakable unity in the world, the unity that man needs to reassure his uncertainty—two marks are always more than one mark and a sum of eight thousand francs is made up of many francs and yet is a whole, a rational organon in terms of which the world can be reckoned up—even that hardy and enduring growth, in which the bourgeois desires so strongly to believe even while all currencies are tottering, is beginning to wither away; the irrational cannot be kept out at any point, and no vision of the world can any longer be reduced to a sum in rational addition" (p. 641).

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> The principal dish at dinner had been croquettes made of turnip greens. So there follows a trifle, concocted out of those dessert powders we use nowadays, that taste like almond soap.[14] (p. 179)

Clearly inflation is adversely affecting the diet of Mann's characters, but something more significant becomes evident here. Cornelius and his family live in a world in which they do not have desserts anymore, they have dessert substitutes. Forced to economize by inflation, these people can no longer afford the real thing:

> These consult together meantime about the hospitality to be offered to the impending guests. The Professor displays a middle-class ambitiousness: he wants to serve a sweet—or something that looks like a sweet. (p. 182)

We are all familiar with this kind of food substitute, an artificial product that is always presented as superior to the real thing, but that is in fact merely cheaper (and perhaps less fattening). Such substitutes are characteristic of life in the twentieth century, and Germany, with its advanced chemical industry, led the way in developing them, so much so that we have taken the German word for substitute, *Ersatz*, into our language.

Thus in his ultimate indictment of the monetary policies of the Weimar Republic, Mann shows how inflation contributes to the ersatz reality of the twentieth century. We have come to live in a world of plywood rather than mahogany. Things are not real anymore; we are surrounded by clever (and cheap) substitutes, mere simulacra of the real things. Mann fills up the story with artificial substitutes, from the false teeth of the children's nurse (p. 189) to the fake leather in Hergesell's shoes:

> They are the tightest I've ever had, the numbers don't tell you a thing, and all the leather today is just cast iron. It's not leather at all. (p. 195)

The artificially heightened pace of the inflationary economy produces more and more irrationalities, including increasing deception in the marketing of commodities. Much of what is traditionally and

[14]The German original (p. 618) is much stronger in conveying a sense of impoverishment; it should be translated: "As main course there were only vegetables, cabbage-cutlets; after that followed a *Flammeri*, composed out of one of those pudding powders one buys now, that taste like almond and soap." A *Flammeri* is a blanc-mange or trifle, but the word also conveys the sense of flummery or deception. Mann uses *Flammeri* in precisely that sense a few pages later (p. 621).

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mistakenly regarded as the duplicity of capitalism is in fact the result of government intervention in the market in the form of tampering with the money supply. As Mann shows, it is primarily the government-induced process of inflation that eats away at the substance of reality in the modern world.

To be sure, one cannot blame everything on inflation. Already in the nineteenth century, Alexis de Tocqueville had noted the tendency of democracies to produce a cheapening of products:

> The handscraftsmen of democratic ages not only endeavor to bring their useful productions within the reach of the whole community, but strive to give to all their commodities attractive qualities that they do not in reality possess. In the confusion of all ranks everyone hopes to appear what he is not. . . . To satisfy these new cravings of human vanity the arts have recourse to every species of imposture.[15]

Thus even before the paper money inflations of the twentieth century, one could detect a movement of the modern economy toward the simulacrum in place of the real thing. De Tocqueville reminds us that economic developments often have political causes, and many of the tendencies Mann portrays in "Disorder and Early Sorrow" can be attributed to the abrupt democratization of Germany after World War I. But Mann shows how inflation works to hasten and heighten these tendencies, forcing people to economize by accepting substitutes in a desperate attempt to maintain the shadow of their former standard of living.

With his novelist's feel for the texture of everyday life, Mann senses the connection between the world of inflation and the world of the modern media. The government creates an illusion of wealth by tampering with the fiduciary media; the communication media similarly contribute to the creation of an all-pervasive world of illusion. Writing in the 1920s, Mann is already aware of how modern technology and the increasingly mediated character of modern life create new possibilities of deception. Every medium of communication is

[15]Alexis de Tocqueville, *Democracy in America*, Henry Reeve, Francis Bowen, and Phillips Bradley, eds. (New York: Vintage, 1959), vol. 2, p. 53. De Tocqueville illustrates this principle with a personal anecdote: "When I arrived for the first time in New York . . . I was surprised to perceive along the shore . . . a number of little palaces of white marble, several of which were of classic architecture. When I went the next day to inspect more closely one which had particularly attracted my notice, I found that its walls were of whitewashed brick, and its columns of painted wood. All the edifices that I had admired the night before were of the same kind" (p. 54). For further thoughts on the connection between democracy and the simulacrum, see Baudrillard, pp. 78–79. Contemporary French thinkers might be surprised to learn how many of their ideas were anticipated by their aristocratic countryman in the nineteenth century.

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potentially a medium of miscommunication. In the masquerades of Bert and Ingrid, the telephone has become an important medium:

> The telephone plays a prominent part . . . : they ring up any and everybody—members of government, opera singers, dignitaries of the Church—in the character of shop assistants, or perhaps as Lord or Lady Doolittle. They are only with difficulty persuaded that they have the wrong number. (p. 184)

The telephone is an example of how the modern communication media create an illusion, the illusion of immediacy. Bert and Ingrid enjoy the sensation of seeming to be in touch with the great public figures of their day, but in a sense, they are as much deceived as the people they try to fool. They think that they are dealing directly with these famous people, but in fact the telephone stands inbetween them; otherwise their deception would not work. Thus any relationship they establish over the phone is inevitably phony; as the German idiom for "wrong number" more forcefully suggests, they are "falsch verbunden" (p. 624), falsely connected.

In a telephone conversation, one does not see the person one is talking to, but has the illusion of being in his presence. Similarly, in a paper money economy, one does not see gold anymore, but the currency gives the illusion of the presence of wealth. The increasingly mediated character of the modern economy, especially the development of sophisticated financial instruments, allows the government to deceive its people about the nature of its monetary policy. When a government tries to clip coins or debase a metal currency, the results are readily apparent to most people. By contrast, the financial intermediation involved in modern central banking systems helps to shroud monetary conditions in mystery. At least initially the techniques of deficit financing and monetarization of debt conceal from the public what is happening to the money supply. Just as the jokes of Bert and Ingrid work only because the people they call cannot *see* them, the Weimar government's inflation worked only because it was hidden behind the smokescreen of modern central banking; with paper money one cannot at first see how the currency is being debased. As Mises has shown, the whole of inflationary policy depends on the confusion in any system of indirect exchange between money and capital, the illusion that pieces of paper are somehow really wealth.

Mann sees the pervasive inauthenticity of the modern world even in the music of the young people, who listen not to real live performances, but to mechanical reproductions on the gramophone. In the

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"new world" created by the gramophone (p. 198), music from all over the globe begins to blend together, and one loses sight of national origins (pp. 198, 199), or the distinction between authentic folk songs and popular hits (pp. 200–1). Seeming to make music from the whole world simultaneously available, the gramophone creates a false aura of cosmopolitan sophistication and thus adds to the sense of cultural relativism:

> They move to the exotic strains of the gramophone . . . : shimmies, foxtrots, one-steps, double foxes, African shimmies, Java dances, and Creole polkas. (p. 204)

Everywhere one looks in "Disorder and Early Sorrow," one sees illusions substituting for reality. The flight from the world of reality is best illustrated by Xaver's fanciful escape into the world of the cinema:

> With his whole soul he loves the cinema. . . . Vague hopes stir in him that some day he may make his fortune in that world . . .—hopes based on his shock of hair and his physical agility and daring. He likes to climb the ash tree in the front garden. . . . Once there he lights a cigarette and smokes it as he sways to and fro, keeping a lookout for a cinema director who might chance to come along and engage him. (p. 203)

Here Mann anticipates what was to become the Hollywood myth of being discovered in Schwab's drugstore. Such dreams are bred by an inflationary economy, which thereby corrupts the ambitions of youth. The young man fantasizes about making his fortune in the movies because he can only imagine becoming wealthy by making one big killing. In an inflationary environment, one must dream of becoming an overnight success because the slow steady way of amassing a fortune by working hard simply will not work. As Mann senses, the moving picture is the perfect art form for the age of inflation: a kinetic art for a kinetic era. He shows how the movies are already saturating everyday life; in his choice of cigarettes, Xaver smokes "a brand named after a popular cinema star" (p. 180). In the illusory world fostered by inflation, an image on a screen now works to shape a man's desires.

VI

The references to telephones, gramophones, and motion pictures in "Disorder and Early Sorrow" build up a sense of how mediated modern life has become, how much we are surrounded by artificial

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reproductions and representations of life. Ultimately the issue of representation becomes central in Mann's story. Studying it carefully, we can see how a reconception of representation has occurred in our century, a major shift in our way of thinking that can be correlated with the shift to paper money and inflationary policies. In the older sense of money, a banknote referred to something outside itself. Under the gold standard, a dollar bill represented a fixed amount of gold, on deposit somewhere and obtainable on demand. That is what it meant to have a currency backed by gold—a paper banknote was redeemable in terms of a real commodity, namely gold, something that had independent value. But in the modern era of fiat money, a banknote just represents another banknote. One dollar bill can merely be exchanged for another dollar bill, but such a transaction has no point anymore, once no real commodity backs the currency. In the modern paper money system, money does not represent anything outside itself; money only represents itself.[16]

What is fascinating is that this change in the concept of representation in fiat money sounds like the prototype for the new concept of representation in modern art. Modern artists pride themselves on their discovery of the principle of non-representational art. Ask a modern painter what his scrawls on the canvas represent and he will patronizingly reply: "My painting doesn't represent anything external to it; it represents itself." Growing out of the nineteenth-century idea of art for art's sake, this attitude in modern art denies that the artist need refer to the external world; his works can exist within the self-contained world of art itself. The world of modern paper money is a similarly closed system. A currency with no commodity like gold backing it thus provides the model for the self-referentiality on which modern art prides itself.[17]

In a case like this it is difficult to speak of cause-and-effect. It would be simplistic to make a statement like: "Because we went off the gold standard, modern art became non-representational." One

[16]To be sure, as long as people have faith in a paper currency, it can be exchanged for real commodities, and in that sense can still be said to represent value. But as the quick collapse of paper currencies like that of Weimar Germany shows, their "reality" is highly attenuated compared to that of gold-backed currencies.

[17]Consider in this context Samuel Beckett's famous formulation of the non-representational character of modern art: "there is nothing to express, nothing with which to express, nothing from which to express, no power to express, no desire to express, together with the obligation to express." See Samuel Beckett, "Three Dialogues," *Disjecta* (New York: Grove, 1984), p. 139. With one substitution, this passage becomes an excellent characterization of the world of paper money as legal tender: "there is nothing to exchange, nothing with which to exchange, nothing from which to exchange, no power to exchange, no desire to exchange, together with the obligation to exchange."

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suspects that both developments have their roots in something deeper in modern life and modern culture, perhaps the democratization de Tocqueville traces. Still, it is worth considering that a change as fundamental as the switch from a commodity-based currency to fiat money might have widespread implications for a society, and might even affect basic cultural attitudes. If self-referentiality is really a defining characteristic of modern art, then perhaps the inflationary environment created by twentieth-century governments at least helped to foster the sense of irreality that pervades our culture. As money ceases to refer to anything real anymore, the traditional idea of referentiality is undermined. The architects of inflationary policy are to blame for many of the disasters, economic and political, of this century. "Disorder and Early Sorrow" suggests that we may also hold them responsible for the empty self-referentiality of much modern art.

Once art becomes severed from reality, artists turn to such notions as the surreal and the hyperreal as substitutes. The whole movement known as postmodernism grows out of the non-representational turn in modern art. We would have to go well beyond the boundaries of Mann's story to explore fully the relation between inflation and postmodernism.[18] One of the central notions of postmodernist theory is the idea of the simulacrum, which we have already seen developed in "Disorder and Early Sorrow."[19] According to one

[18]In *The Post-Modern Aura: The Act of Fiction in an Age of Inflation* (Evanston, Ill.: Northwestern University Press, 1985), Charles Newman attempts to relate postmodernism to the prevalence of inflation in the twentieth century. This book is the most serious attempt I know of to discuss the cultural implications of inflation; see especially pp. 6–7, 187–90, or his summary statement (p. 184): "In cultural matters, inflation abstracts anxiety, suspends judgment, multiplies interpretation, diffuses rebellion, debases standards, dissipates energy, mutes confrontation, undermines institutions, subordinates techniques, polarizes theory, dilates style, dilutes content, hyperpluralizes the political and social order while homogenizing culture. Above all, inflation masks stasis." Unfortunately the book is seriously weakened by Newman's inability to develop a sustained argument; he comes up with some brilliant insights, but fails to develop them systematically. He is also woefully ignorant of economic truth, especially about the nature of inflation, which he claims "is primarily caused not by . . . monetary policy or government spending . . . but by inflationary assumptions anticipated by the entire culture" (p. 167), another case of mistaking the effects of inflation for the cause. One would be hard pressed to find a stupider statement than Newman's judgment on free markets: "every seller constitutes a monopoly to the degree that he has the power to increase prices without affecting sales, and such pricing institutions are not on the whole undesirable, as pure price competition would be totally disruptive of the economy" (p. 165). When literary critics are as ignorant of economic truth as this, it is hardly surprising that their economic analyses of culture are confused. Still, Newman is the only critic I know of who has understood how pervasive and insidious a force inflation has been in twentieth-century culture.

[19]For a general study of the role of the simulacrum in Mann, see Berhard J. Dotzler, *Der Hochstapler: Thomas Mann und die Simulakren der Literatur* (München: Wilhelm Fink, 1991).

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definition, a simulacrum is a copy for which there is paradoxically no original.[20] But that is exactly the concept of fiat money. Under the gold standard, the dollar bill used to be the representation, for which a fixed amount of gold provided the original. In this situation, one could easily distinguish the representation from the original—the original was bright and shiny, while the representation was green and crumpled. But that kind of distinction is no longer possible in the world of pure paper money. One dollar bill merely represents another dollar bill—we are in a world of all copies and no originals.[21]

But this is exactly the kind of world Mann portrays in "Disorder and Early Sorrow," a world in which reality is constantly threatening to dissolve into mere representations of reality. Cornelius is distressed by his son's admiration for and imitation of the actor, Ivan Herzl:

> Bert has entirely succumbed to Herzl's influence, blackens the lower rim of his eyelids . . . and with youthful carelessness of the ancestral anguish relates that not only will he take Herzl for his model if he becomes a dancer, but in case he turns out to be a waiter at the Cairo he means to walk precisely thus. (p. 181)

In choosing an actor as his model, Bert ends up imitating an imitator, and thus threatens to become a mere simulacrum of a human being. What strikes Cornelius about Herzl is his total lack of authenticity; as an actor, he always seems to be putting on a show, and hence not to have any reality of his own:

> It all, no doubt, comes from his heart, but he is so addicted to theatrical methods of making an impression and getting an effect that both words and behavior ring frightfully false. (p. 197)

[20]The idea of the simulacrum is very important in contemporary French thought, particularly in Baudrillard. In *Simulations*, he defines the simulacrum as "the generation by models of a real without origin or reality: a hyperreal" (p. 2), "a liquidation of all referentials . . . substituting signs of the real for the real itself" (p. 4).

[21]That is of course why it is easier to inflate a pure paper currency as opposed to a gold-backed currency. To see how close this situation is to the world of simulacra conceived by Baudrillard, consider his characterization: "The relation between them is no longer that of an original to its counterfeit. . . . objects become undefined simulacra one of the other" (p. 97). That Baudrillard himself senses a connection between his notion of the simulacrum and paper money is shown by the fact that he often speaks of the *circulation* of simulacra; his description of Los Angeles, for example, is an apt characterization of the modern money supply: "a network of endless, unreal circulation" (p. 26; see also pp. 11, 32). Baudrillard makes the connection explicit when he compares the process of simulation to "the floating of currency" (p. 133). It is a curious historical coincidence that the poststructuralists' obsession in the 1970s with what they called "free-floating signifiers" roughly coincided with the end of the gold-exchange standard, which resulted in the free floating of national currencies, wholly uncoupled from any tie to gold.

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Already in the 1920s, Mann prophetically saw the inauthenticity coming to pervade modern society and modern culture, linking this development to the modern communication media, but understanding its link to fiduciary media as well. Indeed his model for the loss of authenticity in the modern world is the loss of the reality of money that inflation causes.[22]

I can offer one particularly apt example to try to corroborate the connection I have been drawing between the epistemology of twentieth-century art and debates over paper money. At the core of postmodernism is the tendency to make the act of representation problematic. Postmodern images call attention to themselves, to the fact that they are merely images. In traditional art, the medium is, as it were, transparent; the artist wants us to look through his act of representation to the thing being represented, and hence does everything possible not to call our attention to his medium. But the postmodern artist throws a wrench into the process of representation, foregrounding his medium and thus making us concentrate on the act of representation itself, on the fact that we are watching something being represented. A famous example of this technique among the Surrealists, forerunners in many respects of postmodernism, is René Magritte's *The Treachery of Images* (Fig. 1). One of the many ways of reading the inscription on this clever painting is: "This is not a pipe; this is merely a representation of a pipe." Magritte short-circuits any tendency we might have to confuse

[22]My poststructuralist colleagues must by now be having a good laugh at my epistemological naïveté in talking about the reality of money; since all money involves an act of representation, they would argue, it is ridiculous to speak of one form of money as being more real than another, and hence I am simply mired in an archaic fetishizing of gold. But making the distinction between a pure paper currency and a gold-backed currency need not involve any essentialist claims about the metaphysical reality of one form of money as opposed to another. In this as in other areas, Austrian economics proves itself to be more subjective in its view of reality than alternate theories (especially Marxism, with its objectivist labor theory of value). For Austrian economics "real" money is simply money the market accepts on its own as real; as Mises shows, any good accepted as money must at least originally have had an exchange value independent of its use as money, that is, it must be a commodity like gold that is subjectively valued for reasons other than its use as a medium of exchange. The opposite of this kind of money is money that the government must force people to accept (legal tender laws). Thus, far from being essentialist, this distinction is purely pragmatic, simply reflecting how people in fact behave. Indeed, long after all governments have abandoned the gold standard, and even labored mightily to demonetize gold, people around the world continue to insist upon treating gold as a form of money, whereas many legal tender currencies are treated as worthless paper by people outside the authority of the governments issuing them. If my colleagues want to persist in claiming that there is no way to view one form of money as more real than another, I have some rubles I would like to trade them at face value for Krugerrands.

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Figure 1
"This Is Not A Pipe"

Source: Original title *La Trahison des Images* (*Ceci n'est pas une Pipe*). René Magritte. Oil on canvas 60. x 81.3 cm. Los Angeles County Museum of Art.

the representation of a thing with the thing itself by explicitly calling attention to his act of representing the thing.[23] The painting leaves us with a lingering sense of the inadequacy and even the duplicity of all acts of representation.

Magritte's painting, done in 1928–29, seems a perfect example of avant-garde art, the kind of work that could only be produced in the twentieth century. And yet it bears a striking resemblance to a famous cartoon by Thomas Nast, drawn as an illustration to David Wells's book, *Robinson Crusoe's Money*, first published in 1876 (Fig. 2). Wells's book was an attack on the paper money inflation brought about by the Civil War. He uses a Crusoe fable to expose the folly of the common people's belief in the reality of paper money:

> But the latter term was conceded to be but a mere fiction of speech and a bad use of language, for every intelligent person at once saw that a promise to deliver a commodity . . . could not possibly be the

[23]For a discussion of this painting, and others like it by Magritte, see Suzi Gablik, *Magritte* (New York: Thames and Hudson, 1985), pp. 124–31. The importance of this painting to poststructuralism is shown by the fact that Michel Foucault wrote a long essay about it, published in English as *This Is Not a Pipe*, James Harkness, trans. and ed. (Berkeley: University of California Press, 1983). Foucault suggests several interesting ways of reading the statement "This is not a pipe." He also connects Magritte's painting to the idea of the simulacrum: "Resemblance predicates itself upon a model it must return to and reveal; similitude circulates the simulacrum as an indefinite and reversible relation of the similar to the similar" (p. 44), once again a peculiarly apt characterization of the illusory world of paper money.

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THIS IS A
HOUSE AND LOT
BY ACT OF THE ARCHITECT
THIS IS
COW
BY THE ACT OF THE ARTIST.
THIS IS A R. STOCK
THIS IS MONEY
BY THE ACT OF CONGRESS.
THIS IS NOT A RAG BABY BUT A REAL BABY BY ACT OF CONGRESS
INFLATED
MILK
MILK-TICKETS FOR BABIES, IN PLACE OF MILK.

Figure 2
Milk-Tickets for Babies, in Place of Milk

Source: David Wells, *Robinson Crusoe's Money; or, the Remarkable Financial Fortunes and Misfortunes of a Remote Island Community* (New York: Harper & Brothers, 1876), p. 57.

commodity or the thing itself, any more than . . . the picture of a horse [is] a horse.[24]

[24]David A. Wells, *Robinson Crusoe's Money; or, the Remarkable Financial Fortunes and Misfortunes of a Remote Island Community* (New York: Harper & Brothers, 1876), p. 57. This fascinating book presents a view of the evolution of money very similar to that developed by Austrian economics, and offers a cogent defense of the gold standard (unfortunately Wells's argument is weakened by his clinging to the labor theory of value and his ignorance of the law of marginal utility). I learned of this book from reading Walter Benn Michaels, *The Gold Standard and the Logic of Naturalism* (Berkeley: University of California Press, 1987), pp. 145–47. Michaels's book is one of the most famous examples of the so-called New Historicism, the kind of deconstructed Marxism that currently dominates literature departments, largely derived from the thinking of Foucault. Michaels develops an intriguing argument about the relation between the gold standard and the concept of representation in nineteenth-century America, in some ways similar to the line I am pursuing. But Michaels cannot take the gold standard seriously, and regards as naïve any attempt to distinguish "real" from "fake" money. On p. 147, he writes: "in insisting that 'good money' must 'of itself possess the full amount of the value which it professes on its face to possess' (p. 26), writers like Wells were insisting that the value of money as money be determined by (and indeed identical to) the value of money as the commodity it would be if it weren't money." Here Michaels reveals his ignorance of economics and his inability to follow Wells's argument. Like the Austrians, Wells argues that money must originally have been a commodity with its own value, but he is perfectly

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Nast's illustration brilliantly captures the heart of this argument by surrealistically confusing things with representations of things. Like Magritte, Nast reminds us that a picture of a cow is not actually a cow, but he is not making a merely aesthetic statement. He is drawing a more serious analogy between the duplicity involved in artistic representation and the duplicity involved in the government printing money and forcibly establishing it as legal tender, an analogy embodied in the parallel: "This is a Cow By the Act of the Artist" and "This is Money by the Act of Congress."[25] Experiencing the Union Greenback inflation, Nast was led to question the reality of representation without benefit of having read Nietzsche. As in "Disorder and Early Sorrow," an inflationary environment raises the issue of the authenticity of representation in a way that provokes an artist to think about the illusions involved in his own craft.[26]

VII

"Disorder and Early Sorrow" may be just a short story, but, as I have tried to show, it is remarkable how complete a portrait of the modern world Mann is able to pack into this brief work, and how rich it is in economic detail. With his attention to the consequences of inflation for daily life, Mann provides a useful supplement to Mises's brilliant economic analysis of the phenomenon. Mises explains what happened in Weimar Germany; Mann gives a sense of how it felt to ordinary people, and in that way may help to convince his readers of the full horror of inflation. Though it may be a rare case, I offer this discussion

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aware that it acquires a new and additional value once it starts to function as a medium of exchange. Michaels is blind to the whole point of the bimetallism controversy he is discussing; if the demonetization of silver in 1873 disastrously lowered the price of silver, as Michaels himself indicates (pp. 144, 175), then there must be a separate component in the value of any commodity serving as money that corresponds specifically to its monetary function, as all the parties to the bimetallism debate acknowledged, including Wells. Michaels's failure to understand this simple point of economics vitiates his whole argument. Given how much contemporary literary critics speak about economic matters, it is astounding how ignorant they remain of economics.

[25]Thinking along the same lines, and trying to find an image for the misrepresentation involved in an inflated currency, Wells is led to imagine the twentieth-century world of the simulacrum, foreseeing the creation of ersatz products: "the painted cotton, silk, wool, and leather could be made to look so exactly like the real articles, that it was only when the attempt was made to exchange the representation for the real that the difference was clearly discernible" (p. 94).

[26]In a final twist on this subject, at the time of the German inflation, Dada artists used real banknotes to create works of art in their collages. Having become virtually worthless, the "real" banknotes turned into imaginary money, one might even say play money. The Hungarian artist, Moholy-Nagy, used a 100 billion mark note in one of his collages. See John Willett, *The Weimar Years: A Culture Cut Short* (New York: Abbeville, 1984), p. 42.

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of "Disorder and Early Sorrow" as an example of how an economic but non-Marxist analysis of literature is possible. Only if one approaches the story armed with the correct analysis of inflation supplied by Mises can one see what its true significance is and what its larger implications are. What is particularly interesting about the story is that it portrays the same world that modernist texts usually do, but offers a different explanation of the characteristics of that world. Mann traces the feeling of modern man that the ground has been pulled out from beneath his feet, not to some metaphysical principle of human life itself, but to the effects of a specific government policy, namely inflation. Moreover, he suggests that the inauthenticity of modern life, which has often been blamed on capitalist practices such as advertising, is more properly viewed as the result of the inflationary environment created by government. The Marxist critics who today dominate humanities departments act as if all economic analysis of literature must yield (for them) comfortingly leftwing conclusions. An Austrian economic analysis of "Disorder and Early Sorrow" shows that many of the problems characteristic of modern life are not, as literary critics tend to claim, the product of private enterprise, but rather of that very government intervention in the economy Marxists always recommend.

The twentieth century could be called the Age of Inflation,[27] the Age of Paper Money, and "Disorder and Early Sorrow" suggests how this fact is related to the prevailing sense of inauthenticity in our time, the sense of a lack of reality and a loss of value. Critics often search as if puzzled to answer the question: how could authors such as Kafka come up with a view of the world as so absurd? The fact is that in its day-to-day consequences the German inflation of the 1920s was far more absurd than anything Kafka could dream up. When Gregor Samsa turns into an insect, it certainly introduces an element of craziness into his household, but at least the money his parents put away in the bank retained its value and allowed life to go on for his family, and when his sister went to do the shopping, she did not need a wheelbarrow to carry the banknotes necessary just to buy a loaf of bread.

It would of course be wrong to blame the development of the idea of the Absurd in modern literature purely on inflation. After all, we can find the Absurd in the literature of countries which never went through anything like the German hyperinflation (though it would be impossible to find any country in this century unaffected by

[27]This name has been given to the twentieth century by Jacques Rueff, *The Age of Inflation*, A. H. Meeus and F. G. Clarke, trans. (Chicago: Henry Regnery, 1964); see esp. p. 1.

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inflation, not even Switzerland; in the modern world, we are always talking only about *relative* rates of inflation; inflation is the most pervasive economic fact of our time). Still, "Disorder and Early Sorrow" gives us much food for thought, and leads us to ask how much of an impact this all-pervasive economic phenomenon has had on modern literature and ways of thinking. Taking our cue from Mann, we begin to question whether inflation may in fact be an even more insidious phenomenon than we have realized, fundamentally altering our world and the way we view it.

Thus in a way very different from Marxist approaches,[28] Mann suggests a connection between the spiritual history of the twentieth century and the economic, making us wonder whether the world became merely an image when money became merely an image. As I said at the beginning, deconstructionist and poststructuralist theories paved the way for Marxist takeovers of humanities departments by calling into question any standards of truth and reality, and thus making the demonstrable failure of socialist economic policies in the real world seem irrelevant in the thinking of literature professors. But analysis of "Disorder and Early Sorrow" suggests that these very theories do not, as they claim, provide insight into the human condition as such, but are in fact just a response to specific economic conditions in the twentieth century, the Age of Inflation. Theorists who triumphantly proclaim the illusoriness of human existence are merely reflecting the world created by government monetary policy, the web of illusions endemic to the era of paper money. In a strange way, one may say that Foucault, Derrida, and the other poststructuralists are right; they have evolved a philosophy appropriate to the Age of Inflation, the age when money itself comes to represent nothing, and hence all representation becomes problematic. The mistake occurs when these philosophers universalize from their limited historical experience, and see the world brought about by Keynesian economics as co-extensive with human life in general. Reading Mann's story can help remind us that it is not human life as such that is unreal—it is the money our governments have surreptitously imposed upon us in an inflationary policy that has caused our sense of reality itself to attenuate in the twentieth century.

[28]Mann himself drew this distinction in a public address: "man braucht nicht materialistischer Marxist zu sein, um zu begreifen, dass das politische Fühlen und Denken der Massen weitgehend von ihrem wirtschaftlichen Befinden bestimmt wird" ("one does not have to be a materialistic Marxist in order to grasp that the political feeling and thinking of the masses is largely determined by their economic condition"). See "Deutsche Ansprache: Ein Appell an die Vernunft," *Gesammelte Werke*, 11: 871.

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The Theory of the Firm: The Austrians as Precursors and Critics of Contemporary Theory

Nicolai Juul Foss*

More than one commentator has observed that a distinct theory of *the firm* is conspicuously missing from the main body of Austrian economics (e.g., Langlois 1991, p. 2; Minkler 1991, p. 8). As two Austrian economists observed some years ago: "there is no subjectivist or Austrian theory of the firm" (O'Driscoll and Rizzo 1985, p. 123). That is still the situation.

With the term "theory of the firm," I shall set forth a theory that has something to say about the existence, the boundaries and the internal organization of the institution known as the business firm. And with the term "firm," I shall describe an organization that is planned with the express purpose of earning profit. In Hayekian terms (Hayek 1973), the firm is a "planned order," an aspect of "taxis."

That social institutions have always occupied center stage in Austrian economics is a proposition that commands widespread agreement today (Hodgson 1988; Langlois 1986, 1991). Many economists recognize the distinctiveness of, for example, the Mengerian theory of the origin of a medium of exchange (Menger 1871, chap. 8), and probably even more economists are familiar with the Hayekian account of the information providing function of the price system (Hayek 1945). Many economists also know that Hayek's insight stemmed from his involvement in the socialist calculation debate, preeminently a debate about the *organization* of economic activities. Indeed, Hayek's "The Use of Knowledge in Society" has become a standard reference in the literature on economic organization (e.g.,

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Ricketts 1987, p. 59; Milgrom and Roberts 1992, p. 56; Douma and Schreuder 1991, p. 9; Williamson 1985, p. 8, 1991, p. 160). More generally, many writers have pointed out the affinities to Austrian economics of much of what passes as "neo-institutionalism," viz. the analysis of social institutions with the aid of economic analysis (Langlois 1986).[1]

So the Austrians have at least since the beginning of the calculation debate with Mises (1920) theorized the organization of economic activities in alternative institutional forms.[2] But the institutions that have traditionally been confronted in Austrian economics are mainly central planning—either in its comprehensive or its market socialism-manifestation—and private property rights–based market organization. This means that hierarchical direction taking place *within* a market economy has been comparatively neglected.[3] Along with many other economists, the Austrians could be seen as assimilating the message of Machlup (1967) that for the purposes of market analysis, one can make do with a very stylized (anonymous) conceptualization of the firm; and economics *per se* had no business breaking up the black box of the firm. In fact, Austrian analysis of market phenomena has even manifested a tendency to dispose of the concept of the firm, resting content with analyzing the extra-Robbinsian—as Israel Kirzner puts it—activities of the entrepreneur.[4]

As I shall show, however, it is something of a doctrinal puzzle that the Austrians have never formulated a theory of the firm. This is so because many of the analytical components that are necessary to tell a coherent story about why there should be firms in a market economy were present in Austrian theorizing long before they became standard fare in neoclassical economics. I have in mind concepts such as property rights (Mises 1936), specific and complementary assets (Hayek 1931), asymmetric information (Mises 1936; Hayek 1937), the

[1]It should be noted that the term "neo-institutional" is often applied generally to modified neoclassical economics (property rights theory) (e.g., Eggertson 1990) as well as more process-oriented and heterodox influences (e.g., Langlois 1986).

[2]When I talk about "Austrians" in this article, I side-step the differences that exist between the Hayekian and the Misesian approaches to Austrian economics. While I do not deny that differences exist, research on this distinction is still only in its beginning. See Salerno (1990).

[3]Among the few Austrian contributions that deal explicitly with the theory of the firm are O'Driscoll and Rizzo (1985, pp. 122–25), Littlechild (1986, p. 35), Boudreaux and Holcombe (1989), Thomsen (1989, chap. 4), and Ikeda (1990). Contributions explicitly influenced by Austrian economics are Malmgren (1961), Ricketts (1987), Witt (1987), Loasby (1989), and Langlois (1991).

[4]The words "firm," "business enterprise" or substitute terms do not figure in the indexes to Menger (1871), Mises (1949), and Lachmann (1956, 1986).

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distinction between planned and spontaneous orders (Hayek 1973), non-maximizing modes of behavior (Mises 1936; Hayek 1973; Kirzner 1973), and a basic understanding of the principal-agent relationship (Hayek 1935a, 1935b, 1940; Mises 1936).[5] These are among the concepts that have occupied center stage in recent attempts to place the theory of the firm on a solid economic footing (e.g., Alchian and Demsetz 1972; Williamson 1985).

This is not to say that the Austrians—had they pieced these concepts together—would necessarily have arrived at something similar or very close to the contemporary theory of the firm. The reason is fundamentally that whereas the modern theory of the firm has had a comparatively loyal relationship to mainstream neoclassical economics, the Austrians have consistently and continuously emphasized their differences from neoclassicism, at least as it took form after World War II. In particular, as the Austrians like to emphasize, the concepts of *market process* and *entrepreneurship* are missing from neoclassical economics in general, and, I may add, from the contemporary theory of the firm in particular. What this implies is that there may be a potential for a distinct Austrian theory of the firm.

The way the ensuing pages proceed is the following. In the next section I present a brief overview of "Contemporary Theories of the Firm," concentrating on the mainstream approach in the contemporary theory of the firm. In "Austrians on Economic Organization," I present some prominent theories and argue that the Austrians anticipated many important modern developments in the theory of the firm. But as I argue in the sections on "An Austrian Critique of the Modern Theory of the Firm" and "Towards an Austrian Theory of the Firm," the Austrians are more than merely precursors; not only is Austrian economics at variance with the modern theory of the firm in some important respects ("An Austrian Critique of the Modern Theory of the Firm"), but it is also possible to construct a distinct theory of why there should be firms on an Austrian basis ("Towards an Austrian Theory of the Firm"). Although the Austrians had (and have) a number of the essential ingredients of the theory of the firm, an Austrian theory of the firm implies adding additional ingredients and piecing them together in ways that differ from the modern theory of the firm. This is the way I resolve the apparent tension in saying that the modern theory of the firm was both anticipated by Austrians and implicitly critiqued by them.

[5]A principal-agent *relation* is said to exist when a principal wants a task to be carried out by an agent on the principal's behalf. A principal-agent *problem* exists when there is some kind of conflict of interest between the two and when the principal either cannot observe the actions of the agent (moral hazard) or cannot ascertain whether the agent has made the best use of the knowledge he possesses (adverse selection).

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In other words, the purposes of this article are historical, critical and constructive, respectively. But in all three tasks, I basically adopt a method of "rational reconstruction": The Austrians can be "reconstructed" as (1) anticipating modern developments, as (2) simultaneously providing a critique of them, and, finally, as (3) having their own distinct perspective on economic organization.

Contemporary Theories of the Firm[6]

The Firm in Economics

The defining characteristic of the market economy is usually taken to be the organization of production and distribution through the price system. But the primacy of exchange is characteristic not only of the market economy but also of how economists view their discipline (McNulty 1984, p. 233). In more specific terms, firms in neoclassical (perfect competition) price theory are often taken to be identical except in terms of the product markets they serve.[7] And not only are firms often presumed to be identical; the actual description of them is the most stylized or anonymous possible. They are merely entrepreneurless production functions. This procedure, of course, is not wrong in itself; for the purpose of analysis of market level allocation it is perfectly defensible (see Machlup 1967).

But as many critics have argued, neoclassical price theory provides no rationale for the very existence of the firm, not to speak of its boundaries and internal organization. This is not just a matter of the price system operating so efficiently that there is no need for, say, any vertically integrated (hierarchical) enterprises; it is more fundamentally a matter of neoclassical perfect competition theory being inherently incapable of rationalizing anything called "the firm." All relevant productive knowledge is given, prices provide all other information, factors are totally mobile, there are no costs of ascertaining quality, etc. This implies that the theory cannot explain why buyers of goods should not simply contract with owners of factor services instead of with firms.

Coase and Post-Coasian Theory

As the story usually goes, it was Ronald Coase who in 1937 realized that not only had the firm been neglected in economics, but more importantly that it was in fact possible to use economic theory

[6]This section draws on material in Foss (1993b).

[7]As argued in Foss (1991) it was the breakthrough of the theory of monopolistic competition in the mid-1930s that established this assumption of uniformity. For an Austrian comment on this episode, see Kirzner (1979, p. 133–35).

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to provide a rationale for why there should be firms in a market economy.[8] Coase's (1937) answer, in a broad outline, is that efficiency requires the substitution of firms for markets if the *transaction costs* of using markets becomes large relative to the costs of managing. Market transaction costs are the costs of discovering contractual partners, drafting and executing contracts. Beyond a central threshold of market transaction costs, hierarchical direction—what Williamson (1991) calls "intentional governance"—of the movements of goods and services becomes more efficient to all involved parties than exchange of property rights through the price mechanism, and what Williamson (1991) following Hayek calls "spontaneous governance." This provides a rationale for the *existence* of the firm.

Applying the conventional marginalist method, the *boundaries* of the firm is determined by the condition that the transaction costs of organizing an additional transaction using the market should equal the transaction costs of organizing that same transaction using the firm. And Coase finally hinted at the possibility of using transaction cost reasoning for explaining the details of internal organization.

Another aspect of the standard account of the development of the contemporary theory of the firm is that the field lay dormant for about 30 years until Armen Alchian, Harold Demsetz, and Oliver Williamson revitalized the Coasian analysis in the beginning of the 1970s (Alchian and Demsetz 1972; Williamson 1975). Indeed, almost all modern theories—most of which have taken their leads from the early seminal contributions of Alchian and Demsetz and Williamson—of the firm are considered post-Coasian in the sense that they view the firm as an efficient contract between a multitude of parties; efficient in the sense that it best facilitates exchange, given existing resource scarcities (including scarcity of information and rationality). In spite of the fact of a common Coasian origin, the contemporary theory of the firm is not monolithic (see, e.g., Holmstrom and Tirole 1989); in their attempts to operationalize, make more precise, and understand the original Coasian insights, modern theories have given rather different answers.

[8]This, of course, is not totally correct since Frank Knight in 1921 had provided an economic rationale for the existence of the firm. Basically, his theory of the firm is closely akin to the way I later in this article interpret the Austrian theory of the firm, since it is basically entrepreneurial: The firm exists as the entrepreneur's means to realize his judgment. For a comparison of Coase's and Knight's theories of the firm, and a ringing endorsement of Knight's theory, see Boudreaux and Holcombe (1989) (and for a moderator, see Foss 1993a).

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In a recent article, Armen Alchian and Susan Woodward (1988) introduced a distinction between a "moral hazard approach" to economic organization, inspired by the original Alchian and Demsetz-analysis (1972), and an "asset specificity approach," best represented by the theorizing of Oliver Williamson (1975, 1985, 1991). The moral hazard approach is usually referred to as "the nexus-of-contracts approach" (Jensen and Meckling 1976; Fama 1980; Cheung 1983), and I shall use that term here. On an overall level, what makes these two approaches different is their degree of adherence to neoclassical theory; whereas the nexus-of-contracts approach is a sort of generalized (property rights) neoclassical theory, the asset specificity approach—particularly in its Williamsonian manifestation—is characterized by the import of a number of non-neoclassical concepts, particularly Herbert Simon's concept of bounded rationality (Simon 1979). They have given correspondingly different answers to Coasian questions like, "What is the precise nature of transaction costs?" "How are they best to be operationalized?" "What determines the size of hierarchical costs?" etc.

The Nexus-of-Contracts Approach

In Alchian and Demsetz's (1972) original analysis the existence of the firm is explainable in terms of the incentive problems that arise when *team production*—production that involves non-separable production functions—is combined with *asymmetric information* and *moral hazard*. In this prisoners' dilemma setting, shirkers do not bear the full consequences (costs) of their actions, and viable shirking is the result. The way the market system copes with such shirking is through contracts. The "classical capitalist firm" is characterized by the existence of one central agent, who is both a monitor who meters the performances of other agents and a residual claimant and with whom other agents enter into contracts. Market forces then guarantee efficient monitoring of team production via the incentive structure confronting the monitor-residual claimant. Viable firms are those that succeed in minimizing the costs involved in monitoring team production.

A number of analytical addenda to this basic story have been presented. Jensen and Meckling (1976) recognized that the monitoring story as told by Alchian and Demsetz was not limited to team production. And Barzel (1987) demonstrated that the agent that was most likely to end up as monitor–residual claimant (principal) was he whose contribution to the joint product was the most difficult to measure.

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Such refinements of the nexus-of-contracts approach came at a cost, however. Though the basic claim was present in Alchian and Demsetz's (1972) original discussion, it became clear that within this tradition the very concept of the firm as a planned order was difficult to uphold. What I ordinarily refer to as "a firm" is simply a complex set of market contracts (Cheung 1983), only distinguished from ordinary spot market contracts by the continuity of association among input owners. Given this, it comes as no big surprise that nexus-of-contracts theorists Eugene Fama (1980) and Steven Cheung (1983) call for an abandonment of the concepts of "the entrepreneur" and "the firm," respectively. Since all allocation of resources—including those "inside" the firm—are ultimately governed by relative price movements there can be little or no room for planned direction of resources as embodied in entrepreneurial plans.[9]

The Asset Specificity Approach

In the same way that the nexus-of-contracts approach seems to have increasingly centered upon one central analytical concept, the cost of metering quality of goods and services, the contractual approach associated with Williamson (1985) has increasingly focused attention on one central character: *asset specificity.* Asset specificity is said to exist when the opportunity cost of an asset is significantly lower than its value in present use. Typically, asset specificity will involve a high degree of *complementarity* among the relevant assets. The difference between these two values is a Marshallian quasi-rent that can be appropriated through *opportunism*. The tussle for rents in bilateral monopoly situations characterized by asset specificity, opportunism, and bounded rationality is the driving force behind firms' changing boundaries. It is, in other words, costly bargaining games that underlie the existence of the firm and its efficient boundaries.

As indicated by Grossman and Hart's (1986) refinement of this mode of analysis, it is not really the contractual "ink costs," and not even the appropriation potential relating to the rents from specific assets that underlies integration *per se*. It is rather the mutual desire to implement efficient investment incentives that determines to whom the ownership rights ("residual rights")—that is, the right to determine and control the use of (physical) assets in circumstances not spelled out in the contract—will be allocated.

One of the really recalcitrant problems in modern debates on economic organization has to do with specifying the costs of internal

[9]A referee pointed out that Armen Alchian under the influence of Williamson has changed his mind on this point. See Alchian (1984, p. 36).

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organization. In the absence of such a specification one cannot solve the puzzle of why the economy is not organized into one big firm (Coase 1937, p. 86). Indeed, Williamson (1985, p. 132) refers to this problem as a "chronic puzzle," and highlights it with his "problem of selective intervention": Why can't a merger of two firms not always do the same or better than two independents, since management in the merger can always intervene selectively?

One of the important attempts to identify the (incentive) costs of internal organization is Milgrom (1988), who basically asks why the hierarchical organization continues to survive in a competitive market economy despite its bureaucratic costs. Applying insights from the rent-seeking literature, Milgrom identifies the sources of bureaucratic costs as subordinate "influence activities," viz. their strategic attempts to change the actions of superiors in their own interest. Such influence activities produce influence costs that usually have a negative impact on firm profitability. As Milgrom argues, centralized authority is particularly vulnerable to influence activities; the decentralized market provides fewer targets. The reason the hierarchy may survive after all is because the existence of strict bureaucratic rules have the beneficial function of dampening the influence activities of subordinates.

Summing up, I highlight the following specific concepts as those that are crucial to telling a story about why there should be firms in a market economy. *Asymmetric information* is absolutely crucial since in the absence of knowledge dispersion there would be no transaction costs; that is, economic organization would be indeterminate. Some notion of *linkedness of resources*—either in the form of Williamson's notion of asset specificity or Alchian and Demsetz's concept of team production—seems also necessary, since in its absence there would be no rents to appropriate. Finally, a notion of *self-interest seeking with guile* (opportunism, moral hazard) also seems necessary, since in its absence there would be no need for the services of a monitor, hierarchical fiat, bureaucracy, etc.; market contracts coupled with promises—that would always be credible—would be sufficient.

On a more general theoretical level, most modern theories of the firm bear an intellectual debt to property-rights theory (Coase 1960; Demsetz 1967). The structure of contracts that constitutes the firm implies an allocation of property rights. Finally, on a methodological level modern theorists of the firm and economic organization are committed to a method of comparative institutionalism which implies that for purposes of comparison the relevant yardstick is not the unattainable ideal of general competitive equilibrium but real, attainable institutions or market outcomes (Demsetz 1969).

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I have asserted that the Austrians in some important areas can be seen as precursors of modern theories of economic organization, including the theory of the firm. In the next section I shall attempt to substantiate that assertion. I shall concentrate attention on the points where the Austrians directly anticipate modern developments and neglect those where there exist variance.

Austrians on Economic Organization

Sifting through the pages of the works of prominent Austrians confirms that while they generally have had very little to say about the theory of the firm *per se*, economic organization and its institutional embodiment have always occupied center stage. The kind of economic organization issues that have primarily occupied Austrian interests are, of course, issues in comparative systems, as represented most notably by the socialist calculation debate (Mises 1920, 1936, 1949; Hayek 1935a, 1935b, 1940, 1937; Lavoie 1985). Assuredly, it is an anachronistic fallacy to criticize the Austrians for not discussing a subject matter that became established in economics only with the beginning of the 1970s. But on the other hand the Austrians had so many of the necessary ingredients of a theory of the firm that it is surprising that it was left to non-Austrian (but subjectivist) Ronald Coase to raise the questions of the existence, boundaries, and internal organization of the firm. To locate some of these ingredients in the Austrian literature is the primary purpose of this section.

Kinds of Orders and Their Governing Rules

Perhaps the most pertinent overall distinctions to be made in a discussion of economic organization are the ones between "pragmatic" and "organic" institutions (Menger 1883) and "planned" and "spontaneous orders" (Hayek 1973). While pragmatic institutions are the results of "socially teleological causes," organic institutions are "the unintended result of innumerable efforts of economic subjects pursuing individual interests" (Menger 1883, p. 158). Menger's discussion is primarily oriented towards giving an explanation of the different ways in which institutions may arise, not to the same extent towards explaining how they are preserved—and their principles of operation—once established. Hayek's (1973) distinction between planned and spontaneous orders supplements Menger's discussion in this regard, since his distinction is based on the different organizing rules they comprise; the rules supporting the spontaneous order being abstract, purpose-independent, and general, while the rules (or

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commands)that support a planned order are designed and specific in nature.[10]

Although Hayek tends to strictly dichotomize not only spontaneous and planned orders but also the relevant rules that direct them—in "nomos" and "thesis," respectively—precise distinctions are in fact difficult to draw, since, for example, spontaneous orders may be of a very different generality, planned orders may comprise elements of spontaneous orders, etc. I shall touch on these issues later on, and for now be content with noting that the distinction between planned and spontaneous orders closely parallels that between "markets and hierarchies" (Williamson 1975), or as Williamson (1991) now says, between "spontaneous" and "intentional governance." Here are some of the meanings I may ascribe to the contrast between these two modes of organizing economic activities:

(1) Full-scale comprehensive planning versus price-mediated exchange on the basis of private property rights.

(2) Market socialism versus price-mediated exchange on the basis of private property rights.

(3) Firm hierarchies versus price-mediated exchange.

(4) Quasi-hierarchies (e.g., joint ventures) or decentralized organizations (e.g., franchising) versus price-mediated exchange.

(5) Firm hierarchies versus government hierarchies.

The distinctions outlined in (1) and (2) were the themes discussed in the socialist calculation debate; (3) is the distinction examined by Coase (1937); (4) has been examined by the followers of Coase, particularly Williamson (1985); and (5) has been examined by property-rights theorists. It is only speculation about the distinctions in (1) and (2) that the Austrians have systematically and comprehensively contributed (Mises 1945 is probably the most comprehensive Austrian contribution to number 5 above). But as I shall briefly argue, the Austrian contributions to the calculation debate

[10]As Hayek (1973, pp. 49, 50) puts it: "[W]hat distinguishes the rules which will govern action within an organization is that they must be rules for the performance of assigned tasks. They presuppose that the place of each individual in a fixed structure is determined by command and that the rules each individual must obey depend on the place which he has been assigned and on the particular ends which have been indicated for him by the commanding authority. . . . [T]he general rules of law that a spontaneous order rests on aim at an abstract order, the particular or concrete content of which is not known or foreseen by anyone; while the commands as well as the rules which govern an organization serve particular results aimed at by those who are in command of the organization."

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provided a number of insights which are extremely pertinent for theorizing about the distinctions presented in (3) through (5).

This is not a novel observation in itself. O'Driscoll and Rizzo (1985, p. 124) report that they find Coase's (1937) insights in economic organization "congenial" because they incorporate "the essential conclusions of the economic calculation debate."[11] And many theorists of economic organization have noted the affinities of Austrian insights in the calculation debate to modern theory (e.g., Williamson 1985, p. 8; Milgrom and Roberts 1992, p. 51). I shall, however, be somewhat more explicit and detailed about where the points of similarity are.

The Socialist Calculation Debate

The Austrian insights presented in the course of the calculation debate that are directly relevant to the theory of economic organization, in the sense that they anticipate modern developments, can be summarized in the following closely connected points:

(1) the insight that welfare assessments of institutions and outcomes should not be based on a "Nirvana approach" (Demsetz 1969);

(2) the importance of change to economic organization;

(3) the understanding that an economic organization should be sensitive to the knowledge and rationality that agents possess; and

(4) an understanding of the principal-agent relationship and the importance of incentives more generally.

To start with the general methodological point, it is apparent already from Mises's (1920) opening salvo in the debate—over later Austrian contributions and until Hayek's "Use of Knowledge" article—that what really irritated the Austrians was their socialist opponents' use of unrealistic and unattainable social ideals—Nirvanas—as standards of comparison. Naturally, on such standards, capitalism would appear inefficient and wasteful. Being the first to insist that socialist economic organization too should be approached with the tools of economic analysis (and that idealized, institutionless models should be banned as standards of comparison), the Austrians may be said to be the first modern economists consistently pursuing the Smithian

[11]Coase does not seem, however, to have been directly inspired by the calculation debate, although his article contains a reference to Hayek's 1933 essay, "The Trend of Economic Thinking." As Coase has later reported (1988), he had the crucial insight already in 1931, well before the calculation debate in its Anglo-Saxon form took place.

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program of comparative institutionalism: that is, using economic analysis to compare the efficiency of alternative real-world institutions for the organization of economic activities.

Now, why exactly was it—in the opinion of the Austrians—that models like Oskar Lange's (1938) model of market socialism did not conform to such a program of comparative institutionalism? The answer is contained in the remaining three points above: (1) The socialist economists neglected the role of incentives (Mises 1936; Hayek 1940); (2) made unrealistic assumptions about the amounts of knowledge that agents can possess (particularly the planning authorities); and (3) formulated their reasoning within static models that obscured all significant economic problems. Or, in a more compact formulation, basing their theories on the economics of the stationary state, market socialists such as Oskar Lange could suppress the knowledge and incentive problems of real economies.

Mises, on the other hand, insisted that "the problem of economic calculation is of economic dynamics; it is no problem of economic statics" (1936, p. 121). And Hayek later seconded Mises when he made the observation that "economic problems arise always and only in consequence of change" (1945, p. 82). As Mises (1936, 1949) recognized, in a changeless stationary state, the political authorities could implement the existing allocation as its plan and everything would continue the way it was before. The lesson to be drawn from this Misesian insight is the general one that it is only when economic change is introduced that economic organization is determinate.[12] And the specific Austrian conclusion in the calculation debate was that in the presence of economic change economic organization on the basis of private property and a price system is strictly superior on efficiency grounds. But the Austrian insight of how change and economic organization are related is of a wider applicability and can be given various interpretations.

One of these interpretations is the general Austrian one, that the entrepreneurial market process is needed to cope with the knowledge problems that economic change introduces (Kirzner 1973), and that market process performs most efficiently when fueled by well-defined and protected private-property rights that provide appropriate incentives for entrepreneurial alertness (Kirzner 1973; Mises 1949).

[12]It is precisely in such a context that Williamson (1985, p. 8 ; 1991, p. 162) praises Hayek (not Mises). Misesian insights appear when Williamson discusses the adaptive properties of the hierarchy and in this context refers to Mises's (1949) distinction between "case probability" and "class probability" (Williamson 1985, p. 58).

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But a more specific and perhaps more pertinent interpretation is to interpret the Austrian insight as anticipating the point that without change there would be no transaction and information costs; that is, in the absence of the knowledge problems introduced by a changing economic reality there would be no costs of discovering contractual partners, drafting and executing contracts, monitoring production, constructing contractual safeguards, judging quality, etc. And in the absence of transaction costs, the choice between price-mediated market transactions and firm hierarchies would be indeterminate. As the Austrians recognized, in real world economies, institutions like markets and hierarchies perform the function of economizing on bounded rationality and dispersed information,[13] precisely the factors that ultimately underlie transaction and information costs.

In a doctrinal perspective, this indicates a link between the Austrian insights in the calculation debate and the Coasian insights in economic organization, though not one that was recognized either by the Austrians or Coase, probably because they had concentrated on different institutions. Where Hayek (1945) praised "the marvel" of the price system, Coase had eight years earlier established that the reason firms existed was that the "telecommunications system" of prices did not perform costlessly. Indeed, some commentators have seen the analysis of Coase and that of Hayek as strongly opposed. Of course, they are not; it is only in the kind of dynamic economic reality visualized by the Austrians that Coase's argument acquires its full force.

On a more specific level, there are several other ways in which Austrian insights presented in the course of the calculation debate anticipate or complement modern insights in economic organization. One of the rapidly expanding areas in the theory of economic organization is principal-agent theory. And in the course of the calculation debate, the Austrians anticipated several insights from this theory. They pointed out that it did *not* follow that under socialism, individual managers (agents) would act in the interest of the principals, viz. the planning authorities (e.g., Hayek 1940). And the Austrians

[13]As Nelson (1981, p. 95) comments: "I propose that serious analysis of the strengths and weaknesses of private enterprise must come to grips with [the] bounded rationality problem. Arguments for private enterprise must take the form that, given man's limitations, patched up private enterprise is as good an organizational solution as can be devised."

It should be noted, however, that the bounded rationality problem that Nelson highlights is not identical with the knowledge problem identified by the Austrians. Whereas Nelson, following Simon, primarily focuses on the problems of processing vast amounts of already existing information, the Austrians focus on the problem of *discovering* the relevant knowledge in the first place. For a careful analysis of this point, see Thomsen (1989, chap. 4).

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pointed out the existence of a problem of risk allocation between principals and agents: under socialism, managers would be either inefficiently risk averse or risk loving, in the face of career concerns and the presence of an institution (the planning authorities) that could act as an insurance institution and take over the moral hazard of individual managers (Mises 1936, p. 122; Hayek 1940, p. 199).

Furthermore, socialist economic organization would supply a number of opportunities for active rent seekers (Mises 1936, 1945, 1949), that is, in modern terminology (Milgrom 1988), it would provide a number of targets for influence activities and be associated with high levels of influence costs. The market socialists, in contrast, had no grasp of the principal-agent problem, or, if they had, assumed it away; as has often been pointed out, Lange (1938) implicitly assumed continual incentive compatibility between the individual managers and the planning authorities. One of the primary virtues of the market system organized on the basis of private ownership, as Mises saw it, was that it strongly mitigated potential principal-agent problems. In the capitalist economy, the

> operation of the market [does] not stop at the doors of a big business concern . . . [It] permeate[s] all its departments and branches . . . It joins together utmost centralization of the whole concern with almost complete autonomy of the parts, it brings into agreement full responsibility of the central management with a high degree of interest and incentive of the subordinate managers. (Mises 1945, p. 47)

Breaking the corporation up into separate profit centers is the way that top management monitors subordinate managers. And anticipating Fama (1980), Mises (1945, pp. 42–7) points to the existence of career concerns as important forces mitigating managers' shirking.

Now, principal-agent theory as well as the specific Austrian incentive arguments in the calculation debate rest on more general property rights–based reasoning. For example, it is fundamentally because agents usually do not have property rights to residual income streams from the productive activities they engage in that they may shirk their duties. Let us briefly examine some Austrian pronouncements on the subject of property rights.

Property Rights

To Menger property rights are directly derived from the facts of scarcity and human rationality; as he notes

> human self-interest finds an incentive to make itself felt, and where the available quantity does not suffice for all, every individual will

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> attempt to secure his own requirements as completely as possible to the exclusion of others . . . Thus human economy and property have a joint economic origin since both have, as the ultimate reason for their existence, the fact that goods exist whose available quantities are smaller than the requirements of men. Property, therefore, like human economy, is not an arbitrary invention but rather the only practically possible solution of the problem that, in the nature of things, imposed upon us by the disparity between requirements for, and available quantities of, all economic goods. (Menger 1871, p. 97)

Ownership to scarce goods—*economic* goods—should be protected by the legal order (Menger 1871, pp. 97, 100); property rights to economic goods will arise under all conceivable circumstances (p. 100), and as regards economic goods it is logically fallacious to think that property rights *per se* can be disposed of under any kind of social organization. With goods that are not scarce, the situation is of course different; here "men are communists" (p. 100). But whether a good is economic or non-economic is fundamentally a subjective category and may change over time; that is, property rights to goods will be defined when goods that were once non-economic become economic.

Menger is one of the very few economists to discuss property rights before Coase, Alchian, and Demsetz in the 1960s laid the foundation for the property-rights approach.[14] And in some respects he anticipates modern developments, particularly in the dynamic perspective in which he places the development of property rights (see Demsetz 1967). But what Menger's discussion does not incorporate is the crucial partitioning of property rights in rights to use goods, appropriate their benefits, and exchange them. Furthermore, he did not investigate how different constellations of property rights influence allocation. It is a general conclusion from the modern property-rights approach that for efficient resource allocation to be fully defined, exclusive, individual, and fully tradeable rights are necessary. Mises came much closer to such insights. In *Human Action* there is a very clear statement of "tragedy of the commons" type problems (1949, p. 652), and the insight that more precise definitions of property rights—"rescinding the institutional barriers preventing the full operation of private ownership"—will eliminate such problems.

But Mises also understood that property rights are composite rights. As he noted, rights to appropriate the rents and profits from assets ("fructus") are crucial to the efficient working of the economy:

[14]The most important contribution in the interim is probably Knight (1924) in which Pigovian welfare analysis is critiqued on property-rights grounds.

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> In an economic system based upon private ownership of the means of production, the speculator is interested in the result of his speculation in the highest possible degree. If it succeeds, then, in the first instance, it is *his* gain. If it fails, then, *he* is the first to feel the loss. The speculator works for the community, but he himself feels the the success or failure proportionately more than the community. (Mises 1936, p. 182)

And one of the reasons why the "artificial market" of market socialists will not work is precisely because the transfer of goods between socialist managers is not equivalent to the transfer of goods in a capitalist economy: Under socialism it is not full property rights that are transferred; prices and incentives are accordingly perverse. On property-rights grounds, it is inherently wrong to believe that "the controllers of the different industrial units" in a socialist economy can be instructed "to act *as if* they were entrepreneurs in a capitalistic state" (1936, p. 120; see also Mises 1949, pp. 702–5).

Where Mises perhaps most explicitly anticipates modern developments—specifically the modern work on how financial markets monitor management—is when he points out that for the efficient functioning of the economy, capital markets are absolutely crucial. They alone secured that the calculation problems in a dynamic economy could be solved through "dissolving, extending, transforming, and limiting existing undertakings, and establishing new undertaking" (1936, p. 215). Only unhampered capital markets and markets for corporate control could perform the two crucial tasks of monitoring management—a principal-agent problem—and pricing assets correctly. Or as Mises summarizes it:

> Under Capitalism, the capitalist decides to whom he will entrust *his own* capital. The beliefs of the managers of joint stock companies regarding the future prospects of their undertakings and the hopes of project-makers regarding the profitability of their plans are not in any way decisive. The mechanism of the money market and the capital market decides. This indeed is its task: to serve the economic system as a whole, to judge the profitability of alternative openings and not blindly to follow what the managers of particular concerns, limited by the narrow horizon of their own undertakings, are tempted to propose. (1936, p. 122)

Contrast this with Lange's (1938, p. 110) assertion about "private corporation executives, who practically are responsible to nobody." Modern theory would be more on Mises's side than on Lange's.

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Capital Theory and Business Cycle Theory

While the connection between the Austrian insights in socialist economic organization and the role of property rights on the one hand and the theories of economic organization seems rather evident, capital theory and business cycle theory seem to be subjects much less connected to the theory of economic organization. The reason these theories are mentioned here is because they supply the last component in the set of concepts that are needed to make a coherent statement about economic organization in general and the firm in particular. The relevant component has to do with the intertemporal structure of production highlighted in Austrian capital and business cycle theory (e.g., Hayek 1931, 1941; Lachmann 1956).

To say that the production process of the economy is a matter of a series of stages of production that bears a temporal relationship to final consumption (Menger 1871; Hayek 1931, 1941; Lachmann 1956) is equivalent to saying that the relevant productive activities are in a relation of *complementarity* to each other. And to say that expansion of credit may introduce maladjustments in the structure of production that has to be worked out over time (Hayek 1931) is equivalent to indicating that some activities may be *specific* to each other (see also Lachmann 1956). These relations can only be adequately understood in a temporal perspective such as the one in Austrian capital theory and business cycle theory (ibid.); they are obscured in the usual production–function view of the productive process. And a phenomenon like vertical integration is much easier to portray and comprehend within a sequential framework like the Austrian than it is within a temporal framework such as the production–function view. As recent work in the theory of the firm has demonstrated, the notions of complementarity between resources—for example, in the form of Alchian and Demsetz's (1972) team production and asset specificity—are necessary to telling a coherent story about firms.

Summing Up

In the preceding sections I have argued that the Austrians anticipated a number of insights that have become central in recent attempts to understand economic organization in general and the firm in particular. The roles of knowledge, incentives, and property rights were strongly in focus in the Austrian theory, particularly in the context of the socialist calculation debate. This provides the opportunity to speculate why the Austrians did not piece all these components together into something like the contemporary theory of economic organization in general and the theory of the firm in particular, and why

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that task was allotted to Ronald Coase. The candidates for explanation are many and very different.

One of them has to do with the allocation of research effort: The Austrians were continuously a rather tiny group of economists (unless a very far-reaching definition of "Austrian" is adopted), and the themes of the time, particularly in the 1930s, were very pressing; the subtle details of the economic organization of capitalist economies may have seemed to be of minor interest compared to debates with the market socialists on large-scale social reorganization, with Keynes on monetary policy, and with meeting the full-scale attack on Austrian capital theory that Frank Knight launched at almost the same time. But these debates meant the virtual elimination of the Austrians as a school.

And herein is a reason why the theory of economic organization in general and the theory of the firm in particular had to await the beginning of the 1970s before it could start blossoming: The virtual elimination of the Austrian school and the increasing focus on institutionless, idealized, formal models following World War II meant that preoccupation with the subject of institutions became regarded as the domain of Veblen-type "old" institutionalists, whom very few formal economists took seriously. However, developments in the 1960s in formal theory—e.g., the economics of information and uncertainty—together with developments in property-rights theory implied that the theory of economic organization could be increasingly addressed with economic tools. But this rather slow process could have been speeded up, had the earlier Austrian insights in economic organization not been so consistently neglected or misrepresented (on this last issue, see Lavoie 1985). Perhaps I may talk about a Kuhnian "loss of content" here.

It would be tempting in this context to say that Austrian theory simply was poorly articulated and "appreciative," not "formal" (these are Nelson and Winter's 1982 concepts). In this interpretation, serious attention to the details of economic organization simply had to await developments in basic microeconomic tools. Now, this may be true on the levels of analytical precision and operationalization. But obtaining his seminal insight, Coase (1937) simply applied the economic tools of his day, that is, substitution at the margin, and added the concept of transaction costs. There is no inherent reason why Austrian theory would not have been able to present a similar insight, particularly not that it was too poorly articulated.

I have to rest content, it seems, with noting that the sort of intellectual creativity that produces new theoretical insights is a function of many factors, particularly a set of components that can

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be pieced together, a specific context that indicates the existence of some important and unexplained phenomenon, and finally a creative spark. As argued, the components were there; but what may have been missing was probably the insight that these components could fruitfully be pieced together into something like a theory of the firm, as well as some intellectual context that could initiate such creativity.[15]

Here it is tempting to propose that it was precisely the Austrian engagement in the calculation debate that blocked the application of general Austrian insights to the theory of the firm. Consider the following reasoning, akin to the one applied by Hayek (1945):

(1) economically important knowledge is local and often tacit;

(2) efficiency dictates that such knowledge be utilized by those who are closest to it;

(3) the market allows this and is, therefore, efficient;

(4) to stay in the market one has to perform efficiently;

(5) but I know that some firms can be observed to stay in the market;

(6) the firm uses centralized decision-making (cf. Minkler 1991, p. 9).

And that violates statement (2). Stated somewhat differently, what the Austrians did not supply was economic principles that could *discriminate* between firm and market on efficiency grounds. To do this was left to Ronald Coase and his later followers.

An Austrian Critique of the Modern Theory of the Firm

In the discussion of the foregoing sections I have deliberately suppressed those points where Austrian theory is in conflict with the modern theory of economic organization in general and the theory of

[15]The most comprehensive older Austrian discussion of economic organization within a capitalist economy appears in Mises's *Socialism* (1936), where vertical and horizontal integration and disintegration—among other things—is discussed in 7 pages (pp. 327–33). Here Mises explains that the firm's optimal size is determined "by the complementary quality of the factors of production," but does not, unfortunately, expand on this (p. 328). The discussion is formulated in the context of the Smithian perspective on the progressive division of labor. Rothbard (1962, pp. 544–50) discusses vertical integration and the size of the firm. Applying Austrian insights from the calculation debate, Rothbard argues that it is increasing calculation difficulties as the firm increases that set limits to the size of the firm. Despite a favorable reference to "the challenging article of R. H. Coase" (p. 901), there is no mention of transaction costs.

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the firm in particular, and highlighted the points where the Austrians could be seen as precursors. But scattered in the Austrian literature there is a critique of contemporary economic orthodoxy that has implications for the theory of the firm, too, and perhaps particularly for the nexus-of-contracts part of modern theory. The critique of orthodoxy I have in mind is the strongly related standard Austrian critique that neoclassical economics is too prone to:

(1) neglect the distinction between spontaneous and planned order (Hayek 1973; O'Driscoll and Rizzo 1985);

(2) neglect the market process (Mises 1949; Hayek 1945; Kirzner 1973; O'Driscoll and Rizzo 1985; Lachmann 1986);

(3) neglect the activities of the entrepreneur (Lachmann 1986); and

(4) objectify costs (Vaughn 1982).

Let us see if this standard critique can be applied to the theory of the firm (see also Boudreaux and Holcombe 1989; Foss 1993a).

Spontaneous and Planned Orders

With regard to the distinction between planned and spontaneous orders there are two fundamental overall errors one can commit at the level of economic organization; the first one is to argue that what looks like a spontaneous market order is in fact the result of the plans of, typically, big enterprise, or more broadly to overlook spontaneous order altogether.[16] Historically, such arguments have been important to many proponents of socialism. The second error is to argue that spontaneous market forces are so pervasive that what looks like planned orders are in reality spontaneous orders. If the first kind of error—the "undervaluation of spontaneous governance" (Williamson 1991, p. 160)—were common in the days of the socialist calculation controversy, it is the second type of error that is committed in modern contributions to the nexus-of-contracts perspective. As "nexus" theorists, Michael Jensen and William Meckling assert,

[16]Simon's (1991, p. 27) parable of the "confused" mythical Martian is illustrative here: The Martian is approaching the Earth with a special telescope that reveals social structures. Boundaries of firms show up as green contours, and market transactions show up as red lines. Simon then states that "A message is sent back home, describing the scene, would speak of "large areas bounded in green connected by a web of red lines." It would not speak of "a network of red lines connecting green spots."

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> it makes little or no difference to try to distinguish those things which are "inside" the firm (or any other organization) from those things that are "outside" of it.
>
> *The firm is not an individual.* It is a legal fiction which serves as a focus for a complex process in which the conflicting objectives of individuals . . . are brought into equilibrium within a framework of contractual relations . . . the behavior of the firm is like the behavior of the market; i.e., the outcome of a complex equilibrium process. (Jensen and Meckling 1976, p. 327)

Assuredly, the firm may itself, in a sense, be said to incorporate aspects of an exchange process, besides being embedded in an overall societal exchange process; after all, a firm's internal organization is characterized by various incentive schemes, such as internal job ladders. But this does not make the firm a spontaneous order, as Jensen and Meckling seem to imply; the relevant exchange process is still subordinate to some overall purpose, which is sufficient to make it qualify as a planned order. Furthermore, conceptualizing the firm the way Jensen and Meckling do basically disposes of the very problem that Coase set out to answer in 1937: Why do firms as planned, hierarchical entities arise at all in a market economy? Since movements of relative prices in the nexus-of-contracts view of economic organization basically underlie all allocation—including that "inside" the firm—there can be no room for entrepreneurship and planned direction of resources (see, for example, Boudreaux and Holcombe 1989). This is the fundamental reason "nexus" theorists Eugene Fama (1980) and Steven Cheung (1983) want to eliminate the concepts of the entrepreneur and the firm, respectively.

The Neglect of Process

The neglect of process is most acutely present in the most neoclassical of modern approaches to economic organization, the nexus-of-contracts approach. Although this approach is probably the one among modern approaches that most emphatically emphasizes the firm's (or, rather, "firm-like organization's") embeddedness in a web of market transactions, no attention is given to the market *process*. All (contractual) outcomes are efficient equilibrium outcomes. Much of this has to do with the way the nexus-of-contracts approach connects to property-rights theory, and particularly the reasoning contained in the Coase theorem (Coase 1960).[17] A common but often

[17] In fact, the nexus-of-contracts approach is much closer to the reasoning in Coase's 1960 contribution than it is to Coase's 1937 contribution (Foss 1993c).

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implicit interpretation of the Coase theorem is that if only property rights are well defined, reaching an optimal state is *unproblematic,* automatic. Of course, this is not so; neglecting problems of the empty core and trading under bilateral monopoly, it is obvious that agents need to *discover* opportunities for profitable trade before they can act on them (Kirzner 1973, p. 227). This process of discovery is neglected in many versions of the Coase theorem and in the nexus-of-contracts approach as well.

Process arguments figure somewhat more prominently in the theorizing of Williamson, particularly in the context of evolution of contract execution. Whereas contracting in the nexus of contracts is efficient on an *ex ante* basis, "the economics of time and ignorance" (O'Driscoll and Rizzo 1985) is present in Williamson's theory to the extent that he attempts to give a real-time account of contract execution (Williamson 1985). One consequence of this is that various *ex post* contracting institutions that exist to mitigate problems of *ex post* opportunism are given considerable attention (see further, Foss 1993a, 1993c). And in seeking the rationale for the existence of the firm, Williamson introduces the concept of "The Fundamental Transformation," viz. the semi-process argument that in the course of contract execution, what was initially a "large numbers" situation with many contractors may turn into a "small numbers" situation (e.g., a bilateral monopoly). But this does not mean that Williamson systematically places the firm or other kinds of economic organization in a market process context. Markets that are "large numbers" are implicitly taken to be in continuous equilibrium.

The Neglect of the Entrepreneur

Neglect of the market process usually goes hand in hand with neglect of the entrepreneur. It is not surprising, then, that the approach that pays least attention to the market process, the nexus-of-contracts approach, is also the one that pays least attention to the activities of the entrepreneur; indeed, it explicitly attempts to dispose of the very concept (Fama 1980). The reason for this, as argued, is the inability within the nexus-of-contracts tradition to uphold the distinction between planned and spontaneous order. Furthermore, the services of the entrepreneur is equivalent to the services of all

[18]See Fama (1980). This assertion goes back to Coase (1937). As he remarked in a critique of Knight (1921), Knight erred in seeing entrepreneurial judgment as a reason for the existence of the firm, since "we can imagine a system where all advice or knowledge were bought as required" (1937, p. 92). Coase totally missed Knight's point: it is precisely because idiosyncratic entrepreneurial judgment cannot be "bought as required" that the firm is needed (see also Boudreaux and Holcombe 1989; and Foss 1993a, 1993b).

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other factor owners, and can be bought on markets as well.[18] Or, in other words, what may look like entrepreneurial services are in fact managerial services. And in the world portrayed in the nexus-of-contracts approach there is in fact no need for the services of the entrepreneur, since all contracting is efficient on an *ex ante* basis, implying that all gains from trade have been discovered and that no reallocations of property rights during contract execution have to take place.

Despite the fact that the account of agency in Williamson's theory is more dynamic than the one in the nexus-of-contracts literature,[19] no attention is given to entrepreneurship. An aspect of this is that questions of innovation and the creation of markets are (deliberately) suppressed (Williamson 1985, p. 142). As Williamson (1985, p. 87) points out, it is a heuristic starting point for his theory that "in the beginning there were markets." And since markets are given, so also are inputs, outputs, and technology.[20] As it is the case with the nexus-of-contracts approach, the agents that occupy Williamson's attention are *managers* of *existing* transactions, shifting transactions over the boundaries of the firm. In Kirzner's (1973) terms, they are "Robbinsian maximizers"; not alert entrepreneurs.

Regarding the neglect of process and entrepreneurship in modern theories of the firm, I may observe that in a sense process arguments and entrepreneurship are necessary for modern theories. Austrian economics and modern theories of the firm can be seen as complementary for the same reason that Hayek's "The Use of Knowledge in Society" and Coase's "The Nature of the Firm" can be seen as complementary: It is precisely in the kind of dynamic economic reality envisaged by the Austrians that questions of economic organization become really pertinent. To update insights from the calculation debate, there would be no transaction or information costs in a stationary state; hence, economic organization would be indeterminate. So I need change to make sense of transaction costs and economic organization. In such an interpretation, modern theories of the firm implicitly appeal to a changing and dynamic reality (Foss 1993a, 1993c). In such a "changing and dynamic reality" transaction costs arise because of the need, among other things, "to discover what the relevant prices are" (Coase 1937, p. 83). But who will perform this act of discovery if not entrepreneurs?

[19]For example, Williamson's concept of "opportunism" is broader than the moral hazard assumption of the nexus-of-contracts tradition.

[20]This is not *strictly* correct since Williamson's "Fundamental Transformation" is a story about changes in inputs and technology (Foss 1993a, 1993b, 1993c).

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On a more general level, it can be argued that the neglect of process and entrepreneurship has meant that the kind of knowledge and coordination problems emphasized in Austrian literature (Hayek 1937; Kirzner 1973) are not present in the contemporary theory of the firm. The firm does not exist because it solves coordination of knowledge-type problems; the reason for its existence lies in incentive considerations. In the nexus-of-contracts approach, the existence of the firm has only to do with mitigating free-rider-type problems; in Williamson's approach, the firm exists to dampen incentives to opportunism (see further, Foss 1993b). As I shall argue in the next section, "Towards an Austrian Theory of the Firm," the type of coordination problems that interest Austrians should be incorporated in a more complete theory of the firm.

Costs

In equilibrium, costs can be said to be "objective" in the sense that they are accurately measured by prices; factors of production, for example, are paid their (marginal) opportunity costs. But outside equilibrium, prices do not fully reflect opportunity costs, simply because the marginal conditions are not satisfied. The inherent subjectivity of costs is only really obvious here. And the equilibrium theorist is therefore too prone to "objectify" costs, to assume, in other words, that real prices accurately measure opportunity costs (Buchanan 1969).

The tendency to neglect the inherent subjectivity of costs is manifest in modern theories of economic organization. This is not just a matter of a lack of a consistent subjectivist (opportunity cost) definition of the concept of transaction costs. It is also a matter of *production costs* not being allowed to influence the make-or-buy decision. As Harold Demsetz (1988, p. 147) has argued:

> The emphasis that has been given to transaction costs . . . dims our view of the full picture by implicitly assuming that all firms can produce goods or services equally well.

This reflects the common simplifying assumption that productive knowledge is given in explicit form to everybody. But given the facts of the dispersion of knowledge (Hayek 1945), the tacit nature of much of the economically relevant knowledge (Hayek 1935b, pp. 154–55; Nelson and Winter 1982), the distribution of entrepreneurial capabilities (Knight 1921), the Smithian benefits of specialization, and the positive costs of information, obviously this cannot be so. So even in equilibrium, production costs will differ. And outside equilibrium,

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production costs may differ even more since factor prices do not measure the entrepreneur's or manager's subjective appraisal of the costs of production. Furthermore, as Hayek (1940, p. 196) points out, low-costs methods of production have to be *discovered* "and discovered anew, sometimes almost from day to day, by the entrepreneur."

What this implies to the theory of economic organization is that (subjective) production costs may in fact enter the make-or-buy decision; entrepreneurs may decide to bring some transaction under the corporate umbrella simply because its implied cost of production in the firm is lower than the price that would have to be paid for it in the market (Foss 1993b).

Summing Up

It seems that the relationship between modern theories of economic organization and Austrian economics is more encompassing than the issues of the Austrians as precursors and critics. In the corpus of Austrian economics, there are a vast number of insights that, as argued in this section, are not present in the contemporary theory of the firm. But there is also a constructive aspect to this, since it is possible to utilize specific Austrian insights not only to supplement existing theories of the firm, but also to construct a distinct Austrian theory of the firm. To argue this is the purpose of the following section.

Towards an Austrian Theory of the Firm

"Clearly, much more work needs to be done on a subjectivist or Austrian theory of firm behavior" (O'Driscoll and Rizzo 1985, p. 125).

A Toolbox

Our Austrian/contemporary theory of the firm toolbox now includes:

(1) a distinction between planned and spontaneous orders;

(2) the market process as a process of entrepreneurial discovery;

(3) property rights (incentives);

(4) specificity and complementarity of assets;

(5) the subjectivity of costs (including production costs);

(6) the private and tacit nature of knowledge ("impactedness"); and

(7) transaction and information costs.

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Let us first examine in which respects some of these Austrian insights may *complement* the contemporary theory of the firm, and then briefly indicate how a distinct Austrian theory may be constructed.

Austrian Economics as Complementing The Contemporary Theory of the Firm

Where Austrian insights have the most to offer to the contemporary theory of the firm is on the level of process and knowledge. To start with the knowledge issue, the Austrian insight that most economically relevant knowledge is local and tacit is not systematically incorporated into contemporary Coasian theories of the firm, at least with regard to production knowledge (Demsetz 1988). In the non-Coasian work of Penrose (1959) and more recently Nelson and Winter (1982) on the theory of the firm, the firm is seen as possessing a set of "capabilities"—stocks of knowledge that are idiosyncratic to the relevant firm—a view of the firm that harmonizes with Hayekian insights about knowledge (Hayek 1945).

As O'Driscoll and Rizzo (1985, p. 124) put it, with reference to Nelson and Winter (1982), this view of the firm furthermore applies "a Hayekian theory of rules and evolved market institutions to firm behavior," in the sense that firms are placed in an evolutionary setting, incorporating both selection through the market and conscious adaptation (though not maximization), and portraying the firm as equipped with a set of "genotypes"—"routines"—on which these effects ultimately operate. Like Hayek's (1973) rules, Nelson and Winter's (1982) routines are stable and mostly tacit patterns of social behavior that are followed—largely unconsciously—because they produced success in the past, i.e., coordinated individual actions relatively successfully. It is from the firm's stock of routines or capabilities that its strategies and actions emerge.

However, not all routines or capabilities are equally efficient. And this provides a room for a view of the market as a continuous disequilibrium process, in which, for example, certain routines are selected against, in the sense that their share of the overall pool of routines is falling, closely akin to the way that Hayek characterizes cultural evolution. Such a view is consistent with Kirzner's (1979, p. 134) point that

> under conditions of disequilibrium, when scope exists for entrepreneurial activity, there is no reason genuine disparities may not exist among different producers.

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Summing up, the "evolutionary" or "capabilities" view of the firm is broadly consistent with Austrian theory since it incorporates decentralized tacit knowledge, learning, and a commensurate role for the entrepreneur.

However, as previously noted, it may be somewhat contradictory to apply insights from the theory of spontaneous order—evolved rules, coordination, etc.—to a planned order, that is, the firm. The market or price system—the paradigmatic spontaneous order—was described by Hayek as

> a sort of discovery procedure which both makes the utilization of more facts possible than any other system, and which provides the incentive for constant discovery of new facts which improve adaptation to the ever-changing circumstances of the world in which we live. (1968, p. 236)

But may we not say that the firm, too, is a learning system in some sense? I think we can, and, in fact, should. But what saves us from committing the failure of identifying what is ultimately a planned order—the firm—as a spontaneous order, is the notion that the firm, like the entrepreneur, learns about *local* facts. The firm is a local learning system, not a global one, such as the spontaneous order of the market.

To put forward such a view of the firm is implicitly to criticize the contemporary (Coasian) theory of the firm. For, as noted, this theory is largely a static affair that pays little or no attention to the creation of markets, and assumes that inputs, outputs and technology are given, so that the economic problem has only to do with combining these in a transaction cost minimizing manner. But it is also to suggest that the Coasian and Austrian/evolutionary/capabilities view of the firm may be fruitfully combined (see also Langlois 1991). Conceptualizing the firm as a learning, evolved entity implies that the transaction costs associated with, for example, the firm's governance of internal transactions may change over time, e.g., may fall.[21] And conceptualizing the market as a learning system, too, implies that transaction costs associated with market exchange will also change. Based on an Austrian process-oriented view, it becomes

[21]This would involve more, for example, than management's increased knowledge about the capabilities of the firm's employees. It would also involve the formation of what business analysts call "corporate culture," that is, a set of stable firm-specific rules that delimits intra-firm behavior. Culture does more than solve Austrian-type coordination problems; it may also dampen various sorts of proclivities to moral hazard, and thus harmonize incentives. For a relevant early discussion, see Malmgren (1961).

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conceptually possible, then, to theorize how the organization of transactions change over time, that is, how the boundaries of the firm change.

Summing up, I may conclude that Austrian insights complement the contemporary (Coasian) theory of the firm to the extent that one wants to go beyond merely addressing the efficient organization of existing inputs and outputs, and incorporate dynamic factors, such as learning. But it is also possible to construct a theory of the firm that is distinctively Austrian. To loosely indicate the character of such a theory is the purpose of the following section.

Elements of an Austrian Theory of the Firm

The Austrian concept that is most conspicuously neglected in the contemporary theory of the firm is probably that of the entrepreneur. Or rather, to the extent that "the entrepreneur" is mentioned, he is identified with the manager (see already Coase 1937). This simply continues a tendency in price theory to "understand the notion of the entrepreneur as nothing more than the locus of profit-maximizing decision-making within the firm" (Kirzner 1973, p. 27). However, the role of the manager is distinct from that of the entrepreneur, since the entrepreneur—to be an entrepreneur—is always occupied with the setup of new means structures. Neither is he *necessarily* to be identified with the owner/manager of the firm; what this last person maximizes *may* not be entrepreneurial profit, but rather Ricardian and Paretian rents from already acquired resources. This leads us back to the founding of firms as the relevant domain for exercising entrepreneurship. As Kirzner (1973, p. 52) explains, the concept of the entrepreneur is primary to that of the firm to the extent that

> The firm . . . is that which results *after* the entrepreneur has completed some entrepreneurial decision-making, specifically the purchase of certain resources.

But when we link this initial entrepreneurial purchase decision to the later existence of the firm, we may in a sense say that the entrepreneur continues his activities to the extent that he deploys the firm's resources in exceptionally profitable ventures.

What should interest us in this perspective is why the firm is needed at all? Why is the firm and entrepreneurial direction of resources necessary? Why is it necessary to make a distinction between "plan complementarity, the complementarity of [resources] within the framework of one plan, and structural complementarity, the overall complementarity of [resources] within the economic system," where

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the first type of complementarity "is brought about *directly* by entrepreneurial action," while the second kind is brought about by the operation of the market (Lachmann 1956, p. 54)? One could, of course, provide Coasian answers to such Coasian questions.[22] But a more congenial, and in some respects also more interesting, way is to look for an explanation in the peculiar character of entrepreneurship.

We have it from Coase (1937) and Fama (1980) that entrepreneurship not only cannot provide a rationale for the firm, but more importantly is largely an irrelevant concept since the entrepreneur's services can be purchased in the market. What some theorists insist on calling an "entrepreneur" is simply an owner of some specialized human capital, whose services have a market price and an opportunity cost. To such assertions, we may invoke such questions as, who *decides* to hire entrepreneurs? Who *discovers* that some agents possess some superior stocks of human capital, etc.? What such questions indicate is that we simply cannot escape using the concepts of entrepreneur and alertness to hitherto undiscovered opportunities if we want to discuss market dynamics of almost any kind. And that is basically Kirzner's point (1973, 1979); to "move" the market, we have to transcend Robbinsian maximizing and add the category of entrepreneurial alertness. Furthermore, as Kirzner argues, entrepreneurship is—*contra* Coase and Fama—categorically different from all other factor services since it has no opportunity cost. Pure entrepreneurship is primarily an act of perception. What has all this to do with the firm?

What is noteworthy about Kirzner's argument is perhaps first of all that he argues that entrepreneurship is fundamentally non-contractible. One interpretation might be that entrepreneurial alertness—or "judgment," as Frank Knight called the same behavioral quality—is so very much inside a given individual's head—that is, tacit—that it is too "impacted" to be traded. In exploiting pockets of ignorance in the market, the entrepreneur applies this knowledge when he discovers what the market did not realize was available or even needed at all. Kirzner's pure arbitrating entrepreneur can in principle do this. But sometimes the realization of the entrepreneur's idiosyncratic judgment will require the formation of a firm.

Fundamentally, there are three different economic ways in which one can utilize knowledge that is specific to oneself:

[22]That would, however, lead one into (fallaciously) identifying the firm with vertical integration. On this, see Boudreaux and Holcombe (1989) and Foss (1993a).

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(1) sell one's services through a contract;

(2) utilize it for arbitrage purposes; or

(3) start a firm.

The options that Kirzner considers are primarily (1) and (2). But option (3) is also relevant. And that brings us somewhat away from Kirzner's theory of the entrepreneur, and closer to the Turgot-Böhm-Bawerk-Rothbard view of the *capitalist*-entrepreneur who also owns capital.[23] One way to interpret option (3) is that non-contractability of entrepreneurial judgment may lead to the formation of a new firm,[24] incorporating a new resource use. The economic reason? There is simply no relevant market through which the entrepreneur's idiosyncratic vision can be communicated; knowledge transmission costs are exorbitant (see Silver 1984). The "telecommunications system of prices" fails as a means of coordination; conscious entrepreneurial direction "supersedes" (Coase 1937) the market.

Notice that this explanation of the existence of the firm has nothing to do with incentives; it is a story about market coordination that fails due to lack of necessary intersubjective points of orientation, that is, lack of so-called "Schelling points."[25] The thing to note about this explanation is that it should appeal to those bent on Austrian subjectivism; it takes to almost an extreme (some would say, seriously) the Austrian notions that "different men know different things" (Hayek) and "different men have different thoughts" (Lachmann).

This explanation can be extended from the issue of the existence of the firm to the boundaries issue. As Lachmann (1956, p. 131) notes:

> We are living in a world of unexpected change; hence, [resource] combinations . . . will be ever changing, will be dissolved and reformed. In this activity we find the real function of the entrepreneur.

Now, in his attempt to carry out his plan the entrepreneur will not bring all the economic activities that are complementary to the

[23]Arguably, Mises took this last position. Thanks to Murray Rothbard for this point.

[24]In Foss (1993a, 1993b) I argue that this was basically Knight's (1921) theory of the firm. It should be noted that in a Knightian context, there is also a moral hazard to firm formation, since the entrepreneur's services—because of their tacitness—are particularly susceptible to moral hazard—and adverse selection problems (on this, see Barzel 1987).

[25]As Malmgren (1961) argued, the emergence of behavior-coordinating Schelling points is not only a characteristic of the market, but perhaps even more of the firm. Fundamentally, when business analysts talk about firms as possessing different "cultures," what they—in this interpretation—mean is that firms come equipped with different Schelling points.

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execution of his under his own ownership. Many goods and services can be acquired through the market without problems. But "in a world of unexpected change" there will sometimes arise a need for new resource combinations, involving, for example, new kinds of inputs. Unexpected change will feed plan revisions. And such revisions may result in changes in the boundaries of the firm. The reason? New combinations of resources will sometimes involve new inputs that are totally specific to the firm (Lachmann 1956). But it is often not possible to transmit precise knowledge about input requirements over the boundaries of the firm without high levels of information costs. Economizing on such costs may dictate internalization of production of the relevant input (Silver 1984).

Furthermore, the entrepreneur may decide to internalize the transaction simply because he thinks that his firm can produce the needed equipment in a more productive cost-effective way than can the market (other firms). The opportunity costs of purchase in the market are prohibitive, not necessarily because of incentive problems because of opportunistic suppliers, but simply because—as the entrepreneur ascertains the situation—the firm can produce more cost-efficiently. The reason? The firm as an evolved entity with a bundle of various resources held together by entrepreneurial direction and the rules that evolve within the framework of purpose defined by the entrepreneur, is fundamentally an entity that is specialized in *knowledge*. And such knowledge is costly to transfer (Demsetz 1988). So whether we look on it from the angle of knowledge-transmission costs or from that of production costs, we are led to a dynamic theory of firm boundaries, one that takes seriously the Austrian notions of dispersal, subjectivity, and tacitness of knowledge.

Conclusion

In the above, I have taken the theme of Austrian economics and economic organization through several variations. I hope to have taken steps towards establishing that not only were the Austrians important precursors of the contemporary theory of economic organization, but they may also contribute to existing theory as well as provide their distinctive perspective on economic organization. Space limitations have dictated, however, that I have been able to only scratch the surface. Assuredly, there is much more to be done on all the three themes I have been discussing, particularly on the last, constructive one.

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F. A. Hayek on Government and Social Evolution: A Critique

Hans-Hermann Hoppe*

As much market as possible, as much state as necessary.
(Motto of the 1959 Godesberg-program of Germany's Socialdemocratic Party)

Thesis One:

Friedrich A. Hayek is generally known as a champion of the free market economy and an outspoken anti-socialist; indeed, Hayek's life was a noble, and mostly lonely struggle against a rising tide of statism and statist ideologies. These facts not withstanding, however:

(1) Hayek's view regarding the role of market and state cannot systematically be distinguished from that of a modern social democrat; and

(2) the immediate reason for Hayek's social democratic views is his contradictory and hence nonsensical definition of "freedom" and "coercion." (Another, fundamental epistemological reason—Hayek's self-contradictory anti-rationalism—will be addressed in Thesis Two.)[1]

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[1]The following essay does *not* consider Hayek's achievements as an economist. As regards these, Hayek deserves great praise. But Hayek's economics is largely the one he adopted from his teacher and mentor Ludwig von Mises and thus is not original with him. What makes Hayek unique, and what fundamentally distinguishes him from Mises, is his political and social philosophy. It is this part of his work, not his contribution to economic theory, that has made Hayek famous. Unfortunately, as will be demonstrated in the following, this *original* part of Hayek's work is entirely false, however.

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On Government

According to Hayek, government is "necessary" to fulfill the following tasks (and may acquire the means necessary to do so through taxation)[2]: Not merely for "law enforcement" and "defense against external enemies," but "in an advanced society government ought to use its power of raising funds by taxation to provide a number of services which for various reasons cannot be provided, or cannot be provided adequately, by the market."[3] (Since at all times an infinite number of goods and services which a market does *not* provide exist, Hayek hands government a blank check.) Among these are "protection against violence, epidemics, or such natural forces as floods and avalanches, but also many of the amenities which make life in modern cities tolerable, most roads . . . the provision of standards of measure, and of many kinds of information ranging from land registers, maps and statistics to the certification of the quality of some goods or services offered in the market."[4] Additional government functions are "the assurance of a certain minimum income for everyone"[5]; government should "distribute its expenditure over time in such a manner that it will step in when private investment flags"[6]; it should finance schools and research as well as enforce "building regulations, pure food laws, the certification of certain professions, the restrictions on the sale of certain dangerous goods (such as arms, explosives, poisons and drugs), as well as some safety and health regulations for the processes of production and the provision of such public institutions as theaters, sports grounds, etc. . . ."[7]; and it should make use of the power of "eminent domain" to enhance the "public good."[8]

Moreover, it generally holds that "there is some reason to believe

[2]See on the following in particular the *Constitution of Liberty* (Chicago: University of Chicago Press, 1960), chap. 15 and part 3; *Law, Legislation, and Liberty* 3 vols. (Chicago: University of Chicago Press, 1973–79), chap. 14.

[3]*Law, Legislation, and Liberty*, 3, p. 41. Compare this to John Maynard Keynes's statement: "The most important Agenda of the state relate not to those activities which private individuals are already fulfilling but to those functions which fall outside the sphere of individuals, to those decisions which are made by *no one* if the state does not make them. The important thing for government is not to do things which individuals are doing already and to do them a little better or a little worse: but to do those things which are not done at all" (*The End of Laissez Faire* (vol. 9), *Collected Writings* [London: MacMillan, 1973], p. 291).

[4]*Law, Legislation, and Liberty*, 3, p. 44

[5]Ibid., p. 55.

[6]Ibid., p. 59.

[7]Ibid., p. 62.

[8]Ibid., pp. 62–63.

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that with the increase in general wealth and of the density of population, the share of all needs that can be satisfied only by collective action will continue to grow."[9]

In the *Constitution of Liberty* Hayek wanted government to provide further for "monetary stability" (while he later on preferred a bizarre scheme for monetary denationalization)[10]; government should implement an extensive system of compulsory insurance ("coercion intended to forestall greater coercion")[11]; public, subsidized housing was a possible government task[12]; likewise, "city planning" and "zoning" were considered appropriate government functions—provided that "the sum of the gains must exceed the sum of the losses"[13]; and lastly "the provision of amenities of or opportunities for recreation, or the preservation of natural beauty or of historical sites or places of scientific interest, . . . natural parks, nature-reservations, etc.," were regarded as government tasks.[14]

Moreover, Hayek insists we recognize that it is irrelevant how big government is or if and how fast it grows. What alone is important is that government actions fulfill certain formal requirements. "It is the character rather than the volume of government activity that is important."[15] Taxes as such and the absolute height of taxation are not a problem for Hayek. Taxes—and likewise compulsory military service—lose their character as coercive measures, "if they are at least predictable and are enforced irrespective of how the individual would otherwise employ his energies; this deprives them largely of the evil nature of coercion. If the known necessity of paying a certain amount in taxes becomes the basis of all my plans, if a period of military service is a foreseeable part of my career, then I can follow a general plan of life of my own making and am as independent of the will of another person as men have learned to be in society."[16] But please, it must be a *proportional* tax and *general* military service!

In light of this terminological hocus-pocus and the above cited list of legitimate government functions, the difference between

[9]Ibid., p. 53.

[10]F. A. Hayek, *Denationalization of Money: The Argument Refined* (London: Institute of Economics Affairs, 1990).

[11]*Constitution of Liberty*, p. 286.

[12]Ibid., p. 346.

[13]Ibid., p. 351. What about Hayek's repeated pronouncements, *qua* economist, that all interpersonal comparisons of utility are scientifically invalid?

[14]Ibid., p. 375.

[15]Ibid., p. 222.

[16]Ibid., p. 143.

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Hayek and a modern social democrat boils down to the question whether or not the postal service should be privatized (Hayek says "yes").

On Freedom and Coercion

The last quote in support of the previous thesis is at the same time confirmation of the thesis that Hayek's social-democratic theory of government finds its explanation in the absurdity of his definition of freedom and coercion.[17]

Hayek defines freedom as the absence of coercion. However, contrary to a long tradition of classical liberal thought, he does *not* define coercion as the initiation or the threat of physical violence against another person or its legitimately—via original appropriation, production or exchange—acquired property. Instead, he offers a definition whose only merit is its fogginess. By coercion "we mean such control of the environment or circumstances of a person by another that, in order to avoid greater evil, he is forced to act not according to a coherent plan of his own but to serve the ends of another,"[18] or "coercion occurs when one man's actions are made to serve another man's will, not for his own but for the other's purpose."[19] Freedom, by contrast, is "a state in which each can use his own *knowledge* [not: his own *property*] for his own purposes."[20]

This definition does not contain anything regarding actions, scarce goods and property. Rather, "coercion" refers to a specific configuration of subjective wills (or plans, thoughts and expectations). Yet then it is useless for the following reason. First, it is useless as a guideline for actions (what am I allowed to do here and now if I do not want to commit a coercive act?), because in general I do not know the will or plans of others and in any case, to know all other wills completely would be impossible. Even if I wanted to, I could never be sure from the outset (*ex ante*) that what I was planning to do would not coerce anyone. Yet individuals obviously must be permitted to act "correctly" *prior* to knowing anything about the plans of others, and even if they knew literally nothing but their own plans.

[17]See on the following Ronald Hamowy, "Freedom and the Rule of Law in F. A. Hayek," *Il Politico* (1970–71); idem, "Hayek's Concept of Freedom: A Critique," *New Individualist Review* (April, 1961); idem, "Law and the Liberal Society: F. A. Hayek's Constitution of Liberty," *Journal of Libertarian Studies* 2 (Winter 1978); Murray N. Rothbard, "F. A. Hayek and the Concept of Coercion," in: idem, *The Ethics of Liberty* (Atlantic Highlands: Humanities Press, 1981).

[18]*Constitution of Liberty*, pp. 20–21.

[19]Ibid., p. 133.

[20]*Law, Legislation, and Liberty*, 1, pp. 55–56.

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For this to be possible, however, the criterion employed to distinguish between "freedom" and "coercion" must be an *objective* one. It must refer to an event/non-event that possesses a *physical* description (and over whose outcome an actor must possess physical control). Second, Hayek's definition is also useless as a retrospective (*ex-post*) criterion of justice (is the accusation of *A* against *B* justified; who is guilty and who isn't?). As long as *A* and *B* come to the *same* conclusion concerning innocence and guilt (including such questions as compensation and/or punishment), no problem arises for Hayek's criterion. However, in the case of unanimity *no* criterion can ever fail. Hayek's criterion fails miserably in those cases, though, for which it is intended: whenever plaintiff and defendant do *not* agree, and still a verdict must be reached. Since Hayek's definition does not contain any physical (intersubjectively ascertainable) criteria, his judgments are arbitrary. As mental predicates, Hayek's categories of freedom and coercion are compatible with every real, physical state of affairs. They possess no power to make *real* distinctions.

Correspondingly confused and contradictory are Hayek's attempts to apply his definitions:

1. In applying his definition, Hayek on the one hand reaches the conclusion that the initiation and threat of physical violence constitutes "coercion." "The threat of force or violence is the most important form of coercion."[21] "True coercion occurs when armed bands of conquerors make the subject people toil for them, when organized gangsters extort a levy for 'protection'."[22] On the other hand (witness the quotations above) he classifies acts of the initiation or threat of physical violence such as compulsory military service or taxes as "non-coercive," provided only that the victims of such aggression could have reliably expected and adjusted to it.

2. On the one hand, Hayek identifies physical violence with "coercion." On the other hand, he does not accept the *absence* of physical violence or damage as a criterion for "non-coercion." "The threat of physical force is not the only way in which coercion can be exercised."[23] Even if *A* has committed no physical aggression against *B* or his property, he may nonetheless be guilty of "coercion." According to Hayek, this is the case whenever *A* is guilty of *omitted help* vis-à-vis *B*, i.e., whenever he has *not* provided *B* with goods or services of his (*A*'s), which *B* had expected from him and regarded as "crucial

[21] *Constitution of Liberty*, p. 135.
[22] Ibid., p. 137.
[23] Ibid, p. 135.

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to my existence or preservation of what I most value."[24] Hayek asserts that only a small number of cases actually fit this criterion: The owner of a mine in a mining town who decides to disemploy a worker allegedly "coerces"; and likewise it is supposedly "coercive" if the owner of the sole water supply in a desert is unwilling to sell this water, or if he refuses to sell it at a price which others deem "fair." But it requires little imagination to recognize that Hayek's criterion is in fact all-encompassing. Any peaceful action a person may perform can be interpreted by others—and indeed any number of them—as constituting "coercion," for every activity is at the same time always the omission of innumerable other *possible* actions, and every omission becomes "coercion" if a single person claims that the execution of the omission was "crucial to the preservation of what I most value."

Whenever cases of omitted help and physical violence are categorically identified as "coercion," however, inescapable contradictions result.[25] If *A*'s omission constitutes "coercion" toward *B*, then *B* must possess the right to "defend" himself against *A*. *B*'s only "defense" would be that he could employ physical violence *against A* (to make *A* execute what he otherwise would avoid doing)—but then acts of physical violence could no longer be classified as "coercion"! Physical violence would be "defense." In this case, "coercion" would be the peaceful refusal to engage in an exchange as well as the attempt to defend oneself against all forced (under the threat of violence executed) exchange. On the other hand, if physical violence were defined as "coercion," then *B* would *not* be allowed to "defend" himself against an omissive *A*; and if *B* nonetheless attempted to do so, then the right to defense would rest with *A*—but in this case, omissions could not constitute "coercion."

3. From these conceptual confusions stems Hayek's absurd thesis of "the unavoidability of coercion" and his corresponding, equally absurd "justification" of government. "Coercion, however, cannot be altogether avoided because the only way to prevent it is by the threat of coercion. Free society has met this problem by conferring the monopoly of coercion on the state and by attempting to limit this power of the state to instances where it is required to prevent coercion by private persons."[26] According to both of Hayek's definitions of

[24]Ibid., p. 136.

[25]See also Murray N. Rothbard, *Power and Market* (Kansas City: Sheed Andrews & McMeel, 1977), pp. 228–34; Hans-Hermann Hoppe, "Von der Strafunwürdigkeit unterlassener Hilfeleistung," in: idem, *Eigentum, Anarchie und Staat* (Opladen: Westdeutscher Verlag, 1977); idem, "On the Indefensibility of Welfare Rights," *Austrian Economics Newsletter* 3 (1989).

[26]*Contitution of Liberty*, p. 21; also p. 141 f.

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"coercion," this thesis is nonsensical. If omitted help represents "coercion," then coercion in the sense of physical violence becomes necessary (not: unavoidable). Otherwise, if the initiation and threat of physical violence is defined as "coercion," it can be avoided; first, because each person possesses control over whether or not he will physically attack another; and second, because every person is entitled to defend himself with all of his means against another's physical attack. It is only unavoidable that so long as physical aggression exists, there will also be a need for physical defense. Yet the unavoidability of defensive violence has nothing to do with the alleged "unavoidability of coercion" (unless one confused the categorical difference between attack and defense and asserted that the threat of defending oneself in the event of an attack is the same kind of thing as the threat of attacking). If physical violence is *forbidden*, then it follows that one is *allowed to defend* oneself against it. It is thus absurd to classify attack and defense under the same rubric of "coercion." Defense is to coercion as day is to night.

Yet from the unavoidability of *defense* no justification for a government monopoly of coercion follows. To the contrary. A government is by no means merely a "monopolist of defense" who helps private individuals avoid otherwise "unavoidable" defense expenditures (as a monopolist: inefficiently). Because it could otherwise provide no defense activities, the government's monopoly of coercion includes in particular the *right* of the state to commit violence against private citizens and their complementary *obligation* not to defend themselves against government attacks. But what kind of justification for a government is this: that if a person surrenders unconditionally to an attacker he may save himself otherwise "unavoidable" defense expenditures?

Thesis Two:

The fundamental epistemological reason for Hayek's nonsensical theory of government and coercion is to be found in Hayek's systematic anti-rationalism.

(1) This anti-rationalism expresses itself first in the fact that Hayek rejects the idea of a cognitive ethic. Hayek is an ethical relativist (who, as already shown, does not even consider an unambiguous moral distinction between attack and defense to be possible).

(2) Second—in an even more dramatic fashion—Hayek's anti-rationalism is expressed in his "theory of social evolution," where purposeful action and self-interest, trial, error and learning, force and freedom as well as

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> state and market (society) have been systematically eliminated as explanatory factors of social change and replaced with an obscure "spontaneity" and a collectivistic-holistic-organizistic principle of "cultural group selection." (Hayek's citation of Carl Menger as precursor of his own theory is false. Menger would have ridiculed Hayek's theory of evolution as mysticism. Menger's successor is not Hayek, but Ludwig von Mises and his "social rationalism."[27])

On Ethics

"Moreover, if civilization has resulted from unwanted gradual changes in morality, then, reluctant as we may be to accept this, no universally valid system of ethics can ever be known to us."[28] Furthermore, "Evolution cannot be just. . . . Indeed, to insist that all future change to be just would be to demand that evolution come to a halt. Evolution leads us ahead precisely in bringing about much that we could not intend or foresee, let alone prejudge for its moral properties."[29] Or: "To pretend to know the desirable direction of progress seems to me to be the extreme of hubris. Guided progress would not be progress."[30] (So much for the question whether or not Hayek can give any advice to the former communist countries of Eastern Europe: he suggests nothing but banking on "spontaneous evolution.")

It is characteristic of Hayek's anti-rationalism that he does not prove this counter-intuitive thesis, as is necessary. Indeed, he does not even attempt to make it plausible.

It is the same anti-rationalism that leads Hayek to state—often merely a few pages apart—something seemingly completely different (logical consistency is not a necessary requirement for an anti-rationalist). For instance, "Where there is no property there is no justice."[31]

[27]The documentation of this parenthetical thesis will be kept to a minimum and relegated to footnotes.

On the fundamental difference between Menger and Mises on the one hand and Hayek on the other see Joseph T. Salerno, "Ludwig von Mises as Social Rationalist," *Review of Austrian Economics* 4 (1990): 26–54; Jeffrey M. Herbener, "Ludwig von Mises and the Austrian School of Economics," *Review of Austrian Economics* 5, no. 2 (1991): 33–50; Murray N. Rothbard, "The Present State of Austrian Economics" (Auburn Ala.: Ludwig von Mises Institute Working Paper, 1992).

[28]F. A. Hayek, *The Fatal Conceit: The Errors of Socialism*, W. W. Bartley III, ed. (Chicago: University of Chicago Press, 1988), p. 20.

[29]Ibid, p. 74.

[30]*Law, Legislation, and Liberty*, 3, p. 169.

[31]*Fatal Conceit*, p. 33; see also the *Constitution of Liberty*, p. 140.

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And John Locke is quoted approvingly with a passage which could not possibly be more rationalist: "'Where there is no property there is no justice', is a proposition as certain as any demonstration in Euclid: for the idea of property being a right to anything, and the idea to which the name injustice is given being the invasion or violation of that right; it is evident that these ideas being thus established, and these names annexed to them, I can as certainly know this proposition to be true as that a triangle has three angles equal to two right ones."[32]

Lastly, it is characteristic of Hayek when only one page later, while one is still wondering how to square the Lockean idea of an Euclidean ethic with the thesis of the "impossibility" of an universally valid ethic, Hayek returns, in a sudden dialectic twist to his relativistic point of departure. "The institutions of property, as they exist at present, are hardly perfect; indeed, we can hardly yet say in what such perfection might consist."[33] "Traditional concepts of property rights have in recent times been recognized as a modifiable and very complex bundle whose most effective combinations have not yet been discovered in all areas."[34] In particular the investigations of the Chicago school (Coase, Demsetz, Becker and others) "have opened new possibilities for future improvements in the legal framework of the market order."[35]

Hayek does not think it worth mentioning or he does not recognize, that the property theories of Locke and the Chicago school are incompatible. According to Locke, the principles of self-ownership, original appropriation (homesteading), production and voluntary exchange are universally valid ethical norms. Locke's theory of private property is a theory of justice, and Locke is an ethical absolutist. In contrast, the representatives of the Chicago school deny the possibility of a rational, universally valid ethic. There exists no justice in Chicago. Who owns what and who does not, and likewise who is the attacker and who the victim, is for Coase and colleagues not once and for all fixed and settled and does not depend on who has done what in the past. Instead, property titles are to be distributed among people, and with changing circumstances redistributed, in such a way that future economic efficiency is maximized. The person who is expected to make the most efficient use of a resource—as "measured" in terms of money—becomes its owner; he who will have to bear the lower monetary costs if he were to avoid the disputed activity is

[32]*Fatal Conceit*, p. 34.
[33]Ibid., p. 35.
[34]Ibid., p. 36.
[35]Ibid.

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declared the attacker in a property-rights dispute; and whenever in the course of time the roles of the most efficient user or the "least cost avoider" change from one person to another, property titles must be accordingly redistributed.[36]

On Social Evolution

The mystic-collectivistic character of Hayek's theory of spontaneous social evolution comes to light in passages such as these:

1. "In the process of cultural transmission, in which modes of conduct are passed on from generation to generation, a process of selection takes place, in which those modes of conduct prevail which lead to the formation of a more efficient order for the whole group, because such groups will prevail over others."[37]

2. "In so far as such rules have prevailed because the group that adopted them was more successful, nobody need ever have known why that group was successful and why in consequence its rules became generally adopted."[38]

3. "Culture . . . is a tradition of learnt rules of conduct which have never been 'invented' and whose function the acting individuals usually do not understand. . . , the result of a process of winnowing and sifting, directed by the differential advantages gained by groups from practices adopted for some unknown and perhaps purely accidental reasons."[39] "Man did not adopt new rules of conduct because he was intelligent. He became intelligent by submitting to new rules of conduct."[40] "We have never designed our economic system. We were not intelligent enough for that. We have tumbled into it and it has carried us to unforeseen heights and given rise to ambitions which may yet lead us to destroy it."[41]

4. Civilization "resulted not from human design or intention but spontaneously: it arose from unintentionally conforming to certain traditional and largely moral practices, many of which men tend to dislike, whose significance they usually fail to understand, whose validity they cannot prove, and which have nonetheless fairly rapidly spread by means of an evolutionary selection—the comparative increase of

[36]See Ronald Coase, *The Firm, the Market, and the Law* (Chicago: University of Chicago Press, 1988); Harold Demsetz, *Ownership, Control, and the Firm* (Oxford: Blackwell, 1988); for a critique see Walter Block, "Coase and Demsetz on Private Property Rights," *Journal of Libertarian Studies* 1, no. 2 (Spring 1977).

[37]F. A. Hayek, *New Studies in Philosophy, Politics, Economics and the History of Ideas* (Chicago: University of Chicago Press, 1978), p. 9.

[38]*Law, Legislation, and Liberty*, 2, p. 5.

[39]*Law, Legislation, and Liberty*, 3, p. 155.

[40]Ibid., p. 163.

[41]Ibid., p. 164.

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population and wealth—of those groups that happened to follow them."[42] "Moral traditions outstrip the capacities of reason."[43] "Mind is not a guide but a product of cultural evolution, and is based more on imitation than on insight or reason."[44]

Hayek's theory, then, consists of these three propositions:

(1) A person initially performs a spontaneous action—without knowing why and for what purpose; and a person retains this practice for no reason—whether or not it has resulted in a success (for without purpose and goal there *can* be no success and no failure). (Cultural mutation.)

(2) The new practice is imitated by other group members—again without any motive or reason. The proliferation of the practice comes to a halt once all group members have adopted it. (Cultural transmission.)

(3) Members of other groups do *not* imitate the practice. Those groups which spontaneously adopt and unconsciously imitate a *better* moral practice will exhibit a comparatively higher population growth, greater wealth, or otherwise somehow "prevail." (Cultural selection.)

Hayek claims that this theory explains the evolution of private property, of the division of labor and of exchange as well as of money and government. In fact, however, these practices and institutions provide perfect examples for demonstrating the theory's entire absurdity (such that Hayek cannot help but contradict his own theory over and again).[45]

Cultural Mutation

Hayek's theory of spontaneity may apply to vegetables (although it would even run into difficulties here because of Hayek's explicitly assumed "Lamarckism"[46]), but it is definitely not applicable to human actors. Every action involves the purposeful employment of scarce means, and every actor can always distinguish between a successful and an unsuccessful action. The concept of an unconscious-spontaneous action à la Hayek is a *contradictio in adjecto*. Acting is always

[42]*Fatal Conceit*, p. 6.

[43]Ibid., p. 10.

[44]Ibid., p. 21.

[45]See on the following also David Ramsey Steele, "Hayek's Theory of Cultural Group Selection," *Journal of Libertarian Studies* 8, no. 2 (1987).

[46]See *The Fatal Conceit*, p. 25.

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conscious and rational. Hence Hayek's theory leads to an inescapable dilemma: If one applies Hayek's theory to itself, then his own activity of writing books is nothing but a purposeless emanation regarding which the questions of true or false and of success or failure simply do not arise. Or Hayek's writing represents a purposeful action. In this case his theory is obviously false, however, because in enlightening himself (and us) regarding the course of social evolution, Hayek no longer acts spontaneously but instead tries to shape social change consciously and rationally.

Regarding in particular the problem of the origin of private property, it is only necessary to insert into proposition (1) practices such as the original appropriation of a previously unowned good or the production of a capital good to immediately recognize its absurdity. Appropriation and capital goods production are purposeful activities. One engages in original appropriation and produces capital goods because one prefers more goods over less and recognizes the greater physical productivity of appropriated land and capitalist production. Even if the *invention* of a capital good such as, for example, a hammer or an axe, first happened by *accident*, the inventor still recognized for what purpose it was useful, and any *repetition* of the invented practice then occurred purposefully and with reason.

Cultural Transmission

Equally absurd is Hayek's theory of "spontaneous association" through unconscious imitation. The imitation of the practices of original appropriation and indirect, capitalist production by others is likewise motivated by the desire for greater personal wealth. It is a justified imitation. Neither external force, chance nor spontaneity are necessary to explain it. Nor are they required in order to then explain the emergence of division of labor and interpersonal exchange. People recognize and have always recognized that division of labor and voluntary exchange lead to greater physical productivity than if one were to remain in self-sufficiency.[47] Likewise, for the origin of a

[47]See Ludwig von Mises, *Human Action. A Treatise on Economics* (Chicago: Henry Regnery, 1966), chap. 8.

"If and as far as labor under the division of labor is more productive than isolated labor, and if and as far as man is able to realize this fact, human action itself tends toward cooperation and association; man becomes a social being not in sacrificing his own concerns for the sake of a mythical Moloch, society, but in aiming at an improvement in his own welfare. Experience teaches that this condition—higher productivity achieved under the division of labor—is present because its cause—the inborn inequality of men and the inequality in the geographical distribution of the natural factors of production—is real. Thus we are in a position to comprehend the course of social evolution" (ibid, p. 160–61). "Liberalism . . . regards all social cooperation as an

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monetary economy one must not wait for a spontaneous mutation. Under conditions of uncertainty, in any barter economy sales-stoppages are bound to arise (whenever a double coincident of wants is absent). In this situation a person can nonetheless still increase his own wealth, if he recognizes that goods may be employed not only for personal use but also as a medium of exchange—for resale purposes—and if he then succeeds in acquiring a more marketable good in exchange for a less marketable one. The demand for a good *qua* medium of exchange further increases this good's marketability. The practice will be imitated by others to solve their own sales problems, and in the course of a self-reinforcing process of imitation, sooner or later a single universal medium of exchange—a commodity money—will emerge, which is uniquely distinguished from all other goods in being the one with the highest degree of resaleability.[48]

None of this is the result of chance. Everywhere, at the origin of private property, exchange and money, individual purpose, insight and self-interested action are at work.

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emanation of rationally recognized utility" (Ludwig von Mises, *Socialism* [Indianapolis, Ind.: Liberty Fund, 1981], p. 418).

Hayek *rejects* this explanation. According to him, to regard as Mises does "all social cooperation as an emanation of rationally recognized utility . . . is wrong. The extreme rationalism of this passage . . . seems to me factually mistaken. It certainly was not rational insight into its general benefits that led to the spreading of the market economy" ("Foreword" to *Socialism,* ibid, p. xxiii). One is wondering how else to explain the phenomenon, but Hayek does not say—except through reference to "spontaneous evolution." Still more wondrous must appear the fact that there existed no human society whatsoever that had no private property and no exchange at all. (Hayek's "primordial bands" [*Law, Legislation, and Liberty*, 3, Epilogue; *Fatal Conceit*, chap. 1] are a myth, similar to the Morgan-Engels myth of primitive communism, for which not a shred of anthropological evidence exists. And the transition from the face-to-face society to the anonymous, faceless economy was not at all a traumatic event which required fundamentally different motives and habits. The world market is nothing else but the sum of all interpersonal transactions and as such not much more difficult to grasp than a simple bilateral exchange of goods.)

Instead, Hayek then engages in an outright falsification when, despite all historical records to the contrary, he appoints Mises to the position of a somewhat less than fully evolved predecessor of his own (Hayek's) theory. "It seems to me that the thrust of Mises's teaching is to show that we have *not* adopted freedom because we understood what benefits it would bring: that we have *not* designed, and certainly were not intelligent enough to design, the order which we now have learned partly to understand long after we had plenty of opportunity to see how it worked. . . . It is greatly to Mises's credit that he largely emancipated himself from that rationalist-constructivist starting point, but that task is still to be completed" (ibid, p. xxiii–xxiv). In fact, Mises never said anything even remotely similar to what Hayek insinuates; and if credit must be given where it is due, Mises must be credited not for having himself emancipated from his rationalism but for never having abandoned it.

[48]See Carl Menger, *Principles of Economics* (New York: New York University Press, 1976), chap. 8; Ludwig von Mises, *Theory of Money and Credit* (Irvington-on-Hudson, N. Y.: Foundation for Economic Education, 1971), chap. 1.

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Indeed, so patently wrong is his theory that Hayek frequently withdraws to a second, more moderate variation. According to this version, division of labor and exchange are "the unintended consequences of human action," "the result of human action but not of human design."[49] The process of human association may not proceed entirely unconsciously, but largely so. An actor may be able to recognize his personal gains from acts of appropriation, production, exchange and money-use—and insofar, the process of evolution may appear rational. However, an actor can*not* recognize the *indirect* consequences of his actions (and it is allegedly these unconscious, unintended consequences for society as a whole which are decisive for the evolutionary success or failure of individual practices). And since *these* consequences can*not* be known, the process of social evolution is ultimately irrational,[50] motivated not by true or false ideas and insights, but by a blind, unconsciously-effective mechanism of group selection.

However, this variant also is contradictory and absurd.

First, it is self-contradictory to characterize actions by their unconscious indirect consequences and then, in the next breath, name these consequences. If the indirect consequences can be named and described, they also can be intended. Otherwise, if they are indeed unconscious, nothing can be said about them. Something about which one cannot say anything, obviously cannot have an identifiable influence on anybody's actions; nor can it be made responsible for the different evolutionary success of different groups. Thus, from the outset it is nonsensical to describe—as Hayek does—the task of a social theorist as that of explaining the "unintended patterns and regularities which we find to exist in human society."[51] The task of the social theorist is to explain the direct as well as the indirect (*not*: the intentional and the unintentional) consequences of human actions and to thus contribute to a progressive rationalization of human action—an expansion of the knowledge of possible (intend-able) goals and the mutual compatibility or incompatibility of various goals.[52]

[49]F. A. Hayek, *Studies in Philosophy, Politics, and Economics* (Chicago: University of Chicago Press, 1967), chap. 6.

[50]Thus Hayek writes that is "perverted rationalism . . . which interpreted the law of nature as the deductive constructions of 'natural reason.'" Law instead is "the undesigned outcome of growth" (ibid., p. 101).

[51]Ibid., p. 97.

[52]At this point, one may want to compare Hayek to his alleged predecessor Carl Menger. For Hayek law is 'the undesigned outcome of growth'. "Our values and institutions are determined not simply by preceding causes but as part of a process of unconscious self-organization of a structure or pattern" (*Fatal Conceit*, p. 9).

In sharp contrast, Carl Menger considers all references in social science explanations to Hayekian categories such as "natural growth," "spontaneous evolution," "primordial

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Secondly, the moderate variation also cannot explain the origin of division of labor, exchange and money. One can grant Hayek initially that it may be possible that a person who carries out an exchange or who acquires a medium of exchange for the very first time will thereby recognize only his own personal gain (but not the indirect, social consequences). He may not know (and mankind at its beginnings certainly did not know) that as an exchanger and a money user he contributes ultimately to the development of a world market, integrated through a single, universally employed commodity money (historically: gold), to steady population growth, to an ever more expansive division of labor and continuously growing global economic wealth. Moreover, it is impossible in principle to predict today (or at any present time) the diversity, quantities, prices and personal distribution of future goods. But from this Hayek's skeptic-anti-rationalist conclusion—that "guided progress is no progress," that "we cannot prejudge the moral properties of evolutionary outcomes," and that "we have never designed our economic system but have tumbled into it, and it may yet lead us to destruction"—does not follow.

For even if a person does not immediately grasp the indirect social consequences of his own actions, it is difficult to imagine how this ignorance could last for long. Once *repeated* exchanges between specific traders occur, or once one sees one's own practice of acquiring a

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nature" or "unconscious self-organization" as sheer mysticism. To *explain* a social phenomenon through forces such as these is not to explain anything at all—a scientific imposture: "The origin of a phenomenon is by no means explained by the assertion that it *was present from the very beginning* or that it *developed originally*. . . . a social phenomenon, at least in its most original form, must clearly have developed from individual factors. The [organicist, Hayekian] view here referred to is merely an analogy between the development of social institutions and that of natural organisms which is completely worthless for the purpose of solving our problem. It states, to be sure, that institutions are unintended creations of the human mind, but not *how* they came about. These attempts at interpretation are comparable to the procedure of a natural scientist who thinks he is solving the problem of the origin of natural organisms by alluding to their "originality," "natural growth," or their "primeval nature" . . . . attempts to interpret the *changes* of social phenomena as 'organic processes' are no less inadmissible than . . . theories which aim to solve 'organically' the problem of the *origin* of unintentionally created social structures. There is hardly any need to remark that the changes of social phenomena cannot be interpreted in a social-pragmatic way, insofar as they are not the intended result of the agreement of members of society or of positive legislation, but are the unintended product of social development. But it is just as obvious that not even the slightest insight into the nature and the laws of the movement of social phenomena can be gained either by the mere allusion to the 'organic' or the 'primeval' character of the processes under discussion, nor even by mere analogies between these and the transformations to be observed in natural organisms. The worthlessness of the above orientation of research is so clear that we do not care to add anything to what we have already said" (Carl Menger, *Investigations into the Method of the Social Sciences with Special Reference to Economics* [New York: New York University Press, 1985], pp. 149–50).

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medium of exchange copied by others, one begins to recognize that one's own actions are not only one-sided but *mutually* beneficial. Even if one were still unable to systematically predict the development of future markets and the shape and composition of future wealth, then, with the nature of a bilateral exchange and a medium of exchange one would at the same time recognize the *principle* of interpersonal justice and of individual and universal economic progress: whatever results emerge from voluntary exchanges are just; and economic progress consists of the expansion of the division of labor based upon the recognition of private property and the universalization of the use of money and monetary calculation. Even if the division of labor, money and economic calculation become *routine* in the course of time, the recognition of the foundations of justice and economic efficiency never again completely disappears. Once for whatever reason it comes to a complete breakdown of the division of labor (war) or the currency (hyperinflation), people will be reminded of it. Then they must not unconsciously await the further course of social evolution—their own extinction. Rather, they are capable of recognizing the breakdown as such and know (and have always known) how to begin systematically anew.

Moreover, as the examples cited by Hayek of Carl Menger and Ludwig von Mises clearly demonstrate, it must not even come to a catastrophe before one regains consciousness. As soon as one has comprehended the thoughts of these men, one can act in full understanding of the social consequences of one's activities. The evolution does not proceed *above* the heads of the acting individuals but instead becomes a process of consciously planned and/or experienced social change. Each progression and each mishap in the process of economic integration can be identified and explained, and the conscious identification of mishaps in particular makes it possible that one may either consciously adjust to a catastrophe *before* it actually occurs or that a mistake will be consciously corrected (insofar as one possesses control over it).

Furthermore, just as people are not condemned to blindly tumble toward self-destruction, they also must not remain passive and powerless vis-à-vis a foreseen economic decline. Rather, at all times one can systematically expand the range of controllable—and hence correctable—mistakes. For any *institutionalized* derailment in the process of economic integration and association—such as government expropriations, taxes, currency depreciations or trade restrictions—must have the approval of the majority of the public. Without such support in public opinion, however reluctant it may be, their continued enforcement becomes impossible. Thus, in order to prevent a

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decline, no more—and no less—than a change in public opinion is necessary; and public opinion can be influenced at all times by ideas and ideologies.[53]

Ironically, an unconscious economic decline is only possible if the majority of the public follows Hayek's advice to act 'spontaneously'—without really knowing why—and free of 'the extreme hubris of knowing the direction of progress'. One cannot act entirely without consciousness, of course. Yet in accordance with Hayek's recommendation one pays attention exclusively to the direct and immediate causes and consequences of one's actions and wealth. In contrast, knowledge and ideas regarding any indirect, to the naked eye invisible causes and consequences are considered unimportant, arbitrary or even illusory. One participates routinely in the division of labor because one recognizes its direct advantage; and one recognizes the direct harm of taxes, currency depreciations and trade restrictions. However, one does *not* recognize that by participating in the division of labor, one at the same time indirectly advances the welfare of all other market participants literally to the last corner of the earth, and indeed that the higher the personal profit, the greater one's contribution to the public good. Nor does one recognize that the direct harm done through government intervention to others, whether in the immediate neighborhood or at the other end of the world, always indirectly diminishes one's own standard of living. Yet this ignorance has fatal consequences; for he who does not understand the indirect causes and consequences of his actions acts differently. He will either act as if the economic advantage or disadvantage of one person has

[53]Since Hayek essentially denies the existence (or the importance) of ideas in the course of social evolution, he also (at least in his later writings) gives no mention to public opinion.

In distinct contrast, David Hume, whom Hayek himself claims as his precursor, attaches fundamental importance to ideas and public opinion. "Nothing appears more surprising to those who consider human affairs with a philosophical eye, than the easiness with which the many are governed by the few, and the implicit submission, with which men resign their own sentiments and passions to those of their rulers. When we inquire by what means this wonder is effected we shall find, that as Force is always on the side of the governed, the governors have nothing to support them but opinion. It is, therefore, on opinion only that government is founded, and this maxim extends to the most despotic and most military governments, as well as to the most free and most popular. The soldan of Egypt, or the emperor of Rome, might drive his harmless subjects, like brute beasts, against their sentiments and inclination. But he must, at least, have led his mamalukes or praetorian bands, like men, by their opinion" (David Hume, *Essays. Moral, Political and Literary* [Oxford: University of Oxford Press, 1971], p. 19).

See also E. de La Boetie, *The Politics of Obedience: The Discourse of Voluntary Servitude*, edited and with an introduction by Murray N. Rothbard (New York: Free Life Editions, 1975); and below, p. 91 ff.

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nothing to do with that of another—and he will accordingly remain neutral or indifferent toward all government intervention which is directed against others. Or he may even act in the belief that one person's gain can be another's loss; and then he may even welcome government expropriation, taxes, currency devaluations or trade restrictions as means of bringing 'restitution' to 'unfair' losers (preferably oneself and one's own kind). As long as this intellectual attitude prevails in public opinion, a steady increase in government expropriation, taxes, inflation and trade restrictions, and the subsequent continuous economic decline, is indeed unavoidable.

However, Hayek's advice is false and nonsensical. It is impossible to act unconsciously or knowingly to be ignorant. And even if the indirect social causes and consequences of one's actions are unknown, they are still—with some delay and however mediated—effective. Thus, to know them is always and for everyone advantageous. The only beneficiary of Hayek's recommendation to the contrary is government. Only the representatives of state and government can have a personal interest in spreading a Hayekian consciousness (while they themselves recognize it as a "false consciousness"), because vis-à-vis an ignorant public it becomes easier for government to grow. Yet the public at large outside the state apparatus has no interest in entertaining a false consciousness (and thus know less than its government). It is personally advantageous to let one's actions be guided by correct ideas, and accordingly one is always receptive to ideological enlightenment. Knowledge is better than ignorance. And because it is better, it is at the same time infectious. However, as soon as the public is enlightened and a majority of it recognizes that everyone's participation in an exchange economy simultaneously benefits all other market participants, and that every government intervention in the network of bilateral exchange relations, regardless where and against whom, represents an attack on one's own wealth, an economic decline is no longer unavoidable. On the contrary, rather than remaining indifferent or even welcoming government intervention, the public will be unsupportive or even hostile to them. In such a climate of public opinion, instead of economic decline, a process of conscious social rationalization and continuously advancing economic integration will result.

Cultural Selection

According to Hayek, however, progress has nothing to do with enlightenment. As little as one is capable of recognizing the reasons for an economic decline, as little is progress due to insight. Just as one tumbles unconsciously and powerlessly into the abyss, so one stumbles

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blindly forward. It is not true or false ideas that determine the course of social evolution, but mystic fate. Progress occurs *naturally*, without any insight of the participating individuals, as one group with coincidentally *better* practices somehow 'prevails' over another with *worse* practices.

Apart from the fact that this theory is incompatible with Hayek's own repeated observation that cultural evolution proceeds faster than biological evolution,[54] it is false for two reasons. First, the theory contains assumptions which make it inapplicable to human societies. Second, when it is nonetheless applied to them, the theory turns out empty and Hayek again reveals himself—intentionally or unintentionally—as a state apologist.

To make his theory work, Hayek first must assume the existence of *separated* groups. Hayek introduces this assumption when he alleges that a new "spontaneous" practice will be blindly imitated *within* a group, but not (why not?) outside of it. If the practice were imitated universally and if, accordingly, there existed only one single group, cultural group *selection* would by definition be impossible. Without some sort of competitor there can be no selection. Moreover, without selection, the concept of progress can no longer be employed meaningfully. All that can be stated regarding a "spontaneously"—without purpose or reason—generated and spontaneously universalized practice is this: that as long as it is practiced, it has not yet died out.

However, the assumption of separated groups, which Hayek must introduce in order to rescue the concept of cultural progress (within his anti-rationalist theory of action and society), immediately produces a series of insurmountable problems for his theory. First, it follows that Hayek's theory cannot be applied to the present. The present world is characterized by the fact that the practices of original appropriation and property, of capital goods production, exchange and monetary calculation are universally disseminated—no group in which these practices are completely unknown and absent exists—and that all of mankind is connected through a network of bilateral exchanges. In this regard, mankind is a single group. Whatever competition between different groups may then exist can have

[54] *Hayek, Law, Legislation, and Liberty*, 3, pp. 154, 156.

As David Ramsey Steele correctly notes ("Hayek's Theory of Cultural Group Selection," p. 179), "if cultural group selection is to be relied upon, human culture would evolve much more slowly than human biology. For the selection of groups is a slower process than the selection of individuals, and group selection according to culture cannot be expected to proceed any faster than group selection according to genes."

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no relevance for these universal practices. Universal practices lie—as a constant—outside of any selection mechanism; and according to Hayek's theory, no more could then be said for the justification of original appropriation, capital goods production, or division of labor and exchange than that such practices have not yet died out.

Hayek's theory is also inapplicable to pre-modern or primitive societies. At this stage in human history, isolated groups existed. Yet even then, the practices of appropriation, production and exchange were universal. There existed no tribe, however primitive, that did not know and practice them. This fact does not cause any problems for a theory of action and society which recognizes these practices as the result of rational, utility-maximizing action. For such a theory, the fact is easily explainable: Each group comes to recognize independently the very same, universally valid rules. But for Hayek, this elementary fact constitutes a fundamental theoretical problem. For if appropriation, production, exchange and money are the result of spontaneous mutation, blind imitation, infection or mechanical transmission, as Hayek claims, it becomes inexplicable—except by reference to chance—why each group, in complete isolation from all others, should come up with the exact same patterns of action. Following Hayek's theory one should expect instead that mankind, at least at its beginnings, would have generated a variety of very different action and society mutants. In fact, if Hayek were correct, one would have to assume that in the beginning of mankind people would have adopted the practice of *not* appropriating, *not* producing and *not* exchanging as frequently as they adopted the opposite. Since this is obviously *not* the case Hayek would have to *explain* this anomaly. Once he identified the obvious reason for this fact, however,—that the adoption of the former practice leads to immediate death,[55] while the latter is an indispensable means for survival—he would have to acknowledge the existence of human rationality and contradict his own theory.

Secondly, even regarding isolated groups Hayek's theory of cultural group selection cannot explain how unconscious cultural progress could be possible. (His explanation of the concept of "prevailing" is accordingly vague.) Isolated groups—and even more so, groups connected by trade—do not compete against each other. The assumption, familiar from the theory of biological evolution, that different organisms are engaged in a zero-sum competition for naturally limited

[55]Besides, this form of extinction also does not fit Hayek's explanatory scheme, for a person or group that would forego all appropriation, production, etc., would die out on account of its own stupidity, not in the course of cultural group selection.

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resources cannot be applied to human societies, and hence any attempt to conclude backward from the survival of a phenomenon to its *better* adaptation (as it is, within limits, possible in biology) fails here. A group of persons isolated from all others, which follows the practices of appropriation, capital goods production and exchange does not thereby reduce the supply of goods of other groups. It enhances its own wealth without diminishing that of others. If it begins to trade with other groups, it even increases their wealth. Between human groups, it is not competition, but self-reliant independence or mutually advantageous cooperation that exists. A mechanism of cultural *selection* thus cannot become effective here.[56]

Hayek, in his self-made theoretical difficulties, nonetheless indicates several possibilities. "Prevailing" means either that one group becomes wealthier than another, that it displays a comparatively higher population growth, or that it militarily defeats and assimilates another one. Apart from the fact that these criteria are mutually

[56]Although Hayek notices some obvious differences between biological and cultural evolution (*Fatal Conceit*, p. 25), he does not recognize the categorical difference between social *cooperation* and biological *competition*. Rather, he writes that biological and cultural evolution "both rely on the same principle of selection: survival or reproductive advantage. Variation, adaptation and competition are essentially the same kind of process, however different their particular mechanism, particularly those pertaining to propagation. Not only does all evolution rest on competition; continuing competition is necessary even to preserve existing achievements" (ibid, p. 26).

In contrast, Ludwig von Mises sharply distinguishes between cooperation and competition. He writes: "Society is concerted action, cooperation. Society is the outcome of conscious and purposeful behavior. This does not mean that individuals have concluded contracts by virtue of which they have founded human society. The actions which have brought about social cooperation and daily bring it about anew do not aim at anything else than cooperation and coadjuvancy with others for the attainment of definite singular ends. The total complex of the mutual relations created by such concerted actions is called society. It substitutes collaboration for the—at least conceivable—isolated life of individuals. Society is division of labor and combination of labor. In his capacity as an acting animal man becomes a social animal" (*Human Action*, p. 143). "What makes friendly relations between human beings possible is the higher productivity of the division of labor. It removes the natural conflict of interests. For where there is division of labor, there is no longer question of the distribution of a supply not capable of enlargement. Thanks to the higher productivity of labor performed under the division of tasks, the supply of goods multiplies. A pre-eminent common interest, the preservation and further intensification of social cooperation, becomes paramount and obliterates all essential collisions. Catallactic competition is substituted for biological competition. It makes for harmony of the interests of all members of society. The very condition from which the irreconcilable conflicts of biological competition arise—viz., the fact that all people by and large strive after the same things—is transformed into a factor making for harmony of interests. Because many people or even all people want bread, clothes, shoes, and cars, large-scale production of these goods becomes feasible and reduces the costs of production to such an extent that they are accessible at low prices. The fact that my fellow man wants to acquire shoes as I do, does not make it harder for me to get shoes, but easier" (ibid, p. 673).

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incompatible—what is the case, for instance, if a more populous group is militarily defeated by a less populous one?—they all fail to explain *progress*. The apparantly most plausible criterion—wealth—fails because the existence of groups with different wealth has no relevance for their survival or extinction. Two groups practice appropriation, production and exchange independently of each other. However, the members of both groups are neither biologically identical, nor is external nature (land) for both groups the same. From this it follows that the results of their actions—their wealth—will be different as well. This is the case for groups and individuals. For individuals, too, it holds that through the application of one and the same practice of appropriation, production and exchange, *different* wealth results. But then the inference from "greater wealth" to "better culture" is illegitimate. The richer person does not represent a *better* culture, and the poorer a *worse* one, but on the basis of one and the same culture one person becomes comparatively wealthier than another. Accordingly, no selection takes place. Both rich and poor co-exist—while as a result of their shared culture, the absolute wealth of rich and poor alike increases.

Likewise, population size fails as a criterion for cultural selection. Group size, too, implies nothing concerning "better culture." Everything that holds for individuals applies to groups as well. From the fact that a person has no biological offspring, it does not follow that he followed other *worse* practices while he was alive. Rather, different individuals acting on the basis of the same rules produce different numbers of offspring. Just as poor to rich, the childless does not stand in competition to those with children. They exist independently of one another or they cooperate with one another. And even if a group should become literally extinct or if an individual committed suicide, this still would not imply any cultural selection. For the surviving follow the very same rules of appropriation, production and exchange which the extinct followed while they were alive.

The third criterion, the military conquest, succeeds in bringing groups out of a state of isolated independence or cooperation into one of zero-sum competition. However, military success no more represents moral progress than a murder indicates the moral superiority of the murderer over his victim. Moreover, the occurence of a conquest (or of a murder) does not affect the validity of *universal* rules, i.e., those that *neither* the murderer *nor* the murdered can do without: In order to introduce a military conflict between groups, Hayek must first make the assumption that in at least one of these groups a new practice spontaneously springs up. Rather than following the practices of original appropriation, capital goods production and exchange,

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someone must have come up with the idea that one can also increase one's personal wealth by forcibly expropriating appropriators, producers and exchangers. However, as soon as this practice is then, according to Hayek's theory, blindly imitated by all other group members, a war of each against all would ensue. There would soon be nothing left that could still be expropriated, and all group members would die out—not because of a mechanism of cultural displacement or selection, but because of their own stupidity! Every person can independently appropriate, produce and exchange, but not everyone can expropriate appropriators, producers and exchangers. In order for expropriations to be possible, there must be people who continue to follow the practice of appropriation, production and exchange. The existence of a culture of expropriation requires the continued existence of a culture of appropriation, production and exchange. The former stands in a *parasitic* relationship to the latter. Then, however, military conquest cannot generate cultural progress. The conquerors do not represent a fundamentally different culture. Among themselves the conquerors must follow the same practice of appropriation, production and exchange, which was also followed by the conquered. And *after* the successful conquest, the conquerors must return to these traditional practices—either because all the conquered have died out or all booty has been consumed, or because one wishes to institutionalize one's practice of expropriation and therefore needs an ongoing productive population (of conquered people).

However, as soon as Hayek's theory is applied to this only conceivable case of cultural competition (rather than of independence or cooperation) in which a subgroup (the conquerors) follows a parasitic culture of expropriation while the rest of the group (the conquered) simultaneously appropriates, produces and exchanges, the result is an unabashed apology for government and state.

This manifests itself first in the way in which Hayek's theory explains the origin of a culture of expropriation. Just as the culture of appropriation, production and exchange is allegedly the result of an accidental mutation, so the practice of expropriation represents a "spontaneous" development. Just as appropriators, producers and exchangers do not understand the meaning of their activities, so the conquerors do not grasp the meaning of conquest. As appropriators, producers and exchangers recognize the immediate personal advantage of their activities, so the conquerors can recognize their personal gain from acts of expropriation. Yet as the participants in a market economy are then not capable of understanding that through their activities the wealth of all other participants is simultaneously

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increased, so the conquerors cannot know that through expropriations the wealth of the expropriated is reduced. Put bluntly: A group of murderers, robbers or slave hunters does not know that the murdered, robbed or enslaved suffer thereby from a loss. They follow their practices as *innocently* as the murdered, robbed and enslaved follow their different practices of appropriation, production and exchange. Expropriation, taxes or trade restrictions are just as much an expression of human spontaneity as are appropriation, production and trade. Every group of conquerors will thank Hayek for so much (mis-) understanding!

Second, Hayek's theory fails just as lamentably in its attempt to explain the rise and fall of historical civilizations—and thereby once again yields absurd statist implications. Indeed, what more could a group of conquerors want to hear than that its own actions have nothing to do with the rise and decline of civilizations. Yet is is precisely this that Hayek's theory implies: For, according to Hayek, cultural progress is only possible, as long as one culture can somehow "prevail" over another. Regarding the relationship between a basic culture of appropriation and a parasitic subculture of expropriation, however, there can be no "prevailing." The parasitic culture cannot prevail, yet as a subculture it can continue to operate as long as a basic culture of appropriation exists. Progress through group selection is impossible within this relationship; and according to Hayek, then, strictly speaking nothing can be stated at all regarding the further course of social evolution. Because the members of the culture of appropriation supposedly do not comprehend that they promote the social welfare through their actions, and because the members of the expropriation culture are equally ignorant of the fact that their actions reduce the general welfare, spontaneous changes in the relative magnitude of both cultures may occur. Sometimes the culture of appropriation will attract more spontaneous adherents; at other times the culture of expropriation will. However, since there is no reason that such spontaneous changes, if they occur at all, should follow any specific—predictable—pattern, there is also no recognizable relationship between spontaneous cultural changes and the rise and fall of civilizations. Everything is chance. No explanation for the rise and the fall of the Roman civilization exists. Likewise, no comprehensible reason for the rise of Western Europe or the United States exists. Such a rise could just as well have happened elsewhere—in India or Africa. Accordingly, it would be "extreme hubris," for instance, to advise India or Africa from the standpoint of Western Europe; for this would imply—oh, how presumptuous—that one knew the direction of progress.

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If this theory is rejected as empty, however, and it is pointed out that from the very description of the initial situation—the coexistence of a basic culture of appropriation and a parasitic subculture of expropriation—a fundamental law of social evolution follows, Hayek's entire anti-rationalist system once again breaks down. A relative expansion of the basic culture leads to higher social wealth and is the reason for the rise of civilizations; and a relative expansion of the parasitic subculture leads to lower wealth and is responsible for the fall of civilizations. Yet if one (anyone) has grasped this plain and elementary relationship, then the origin and the relative changes in the magnitudes of both cultures can no longer be interpreted as a *natural* process. The explanation, familiar from biology, of a natural, self-regulated equilibration process—of spontaneously growing parasites, a weakening of the host, a consequent shrinking number of parasites, and finally the host's recovery, etc.—cannot be applied to a situation where host and/or parasite are consciously aware of their respective roles as well as the relationship between them and are capable of choosing between these roles. A comprehended social evolution is no longer natural, but rational. So long as only the members of the parasitic culture understand the nature of the relationship, instead of a natural up and down of both cultures a planned, steady growth of parasitism will ensue. The members of the parasitic subculture do not vacillate between first faring absolutely better and then absolutely worse. Rather, because of their insight into the relationship between the culture of appropriation and that of expropriation they can act in such a way—by *not* expanding their practices spontaneously, but instead consciously restraining themselves—that their own absolute wealth will always grow (or at least will never fall). On the other hand, to the extent that the members of the basic culture understand the nature of the relationship between both cultures, not only the absolute wealth of the subculture will be threatened but its sheer existence will be endangered. For the members of a parasitic subculture always represent only a minority of the whole group. One hundred parasites can lead a comfortable life on the products of one thousand hosts. Yet one thousand parasites cannot live off of one hundred hosts. If, however, the members of the productive culture of appropriation always represent a majority of the population, then in the long run the greater physical strength is on their side as well. They can always physically defeat and destroy the parasites, and the continued existence of a subculture of appropriation is then *not* explained by its greater physical-military power, but rather depends exclusively on the power of *ideas*. Government and state must find ideological support which reaches far into the

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exploited population. Without such support from the members of the basic culture, even the most brutal and seemingly invincible government immediately collapses (as most recently illustrated dramatically by the fall the Soviet Union and the communist governments of Eastern Europe).

The changes in the relative magnitude of the basic culture and the parasitic subculture that explain the rise and fall of civilizations are in turn explained by *ideological* changes. They do not occur spontaneously but are the result of conscious ideas and their dissemination. In a society in which a majority of the basic culture comprehends that each act of appropriation, production, and exchange enhances the welfare of all other market participants, and that each act of expropriation, taxation or trade restriction instead, regardless against whom it is directed, lowers the welfare of all others, the parasitic culture of government and state will continuously die off and a rise of civilization will ensue. On the other hand, in a society in which the majority of the basic culture does not understand the nature and relationship between basic and subculture, the parasitic expropriation culture will grow and with this a decline of civilization will ensue.[57]

Hayek, who wants to ban ideas and rationality from the explanation of history, must deny all this. Yet in proposing his own theory of unconscious cultural group selection, he too affirms the existence and effectiveness of ideas, and he too acknowledges—whether he is aware of this or not—that the course of social evolution is determined by

[57]Writes Mises: "History is a struggle between two principles, the peaceful principle, which advances the development of trade, and the militarist-imperalist principle, which interprets human society not as a friendly division of labor but as the forcible repression of some of its members by others. The imperialist principle continually regains the upper hand. The liberal principle cannot maintain itself against it until the inclination for peaceful labor inherent in the masses shall have struggled through to full recognition of its own importance as a principle of social evolution" (*Socialism*, p. 268). "Liberalism is rationalistic. It maintains that it is possible to convince the immense majority that peaceful cooperation within the framework of society better serves the rightly understood interests than mutual battling and social disintegration. It has full confidence in man's reason. It may be that this optimism is unfounded and that the liberals have erred. But then there is no hope left for mankind's future" (idem, *Human Action*, p. 157). "The body of economic knowledge is an essential element in the structure of human civilization; it is the foundation upon which modern industrialism and all the moral, intellectual, technological, and therapeutical achievements of the last centuries have been built. It rests with men whether they will make proper use of the rich treasure with which this knowledge provides them or whether they will leave it unused. But if they fail to take the best advantage of it and disregard its teachings and warnings, they will not annul economics; they will stamp out society and the human race" (ibid, p. 885).

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ideas and their adoption. Hayek produces ideas and wants to influence the course of human history through ideas, too. However, Hayek's ideas are false; and their proliferation would lead to the eclipse of Western civilization.

Conclusion

Friedrich Hayek is today acclaimed as one of the most important theoreticians of the market economy and of classical liberalism. Far more than his earlier work in the field of economic theory, his later writings on political philosophy and social theory have contributed to his fame. It is these later writings that currently support and feed an extended, international Hayek dissertation industry.

The preceding investigations demonstrate that Hayek's excursions into the field of political and social theory must be considered a complete failure. Hayek begins with a self-contradictory proposition and ends in absurdity: He denies the existence of human rationality or at least the possibility of recognizing all indirect causes and consequences of human action. He claims that the course of social evolution and the rise and fall of civilizations is incomprehensible, and that no one knows the direction of progress (only to explain progress then as the result of some unconscious process of cultural group selection). He claims that no universally valid ethical standards exist, and that it is impossible to make an unambiguous moral distinction between an attack and a defense or between a peaceful refusal of exchange and a physically coerced exchange. And lastly, he claims that government—whose causes and consequences allegedly are as incomprehensible as those of the market—should take on (financed by taxes) all those tasks which the market does not provide (which anywhere outside of the Garden of Eden amounts to an infinite number of tasks).

Our investigations support the suspicion that Hayek's fame has little to do with his importance as a social theorist, but rather with the fact that his theory poses no threat whatsoever to the currently dominating statist ideology of social democracy, and that a theory which is marked by contradiction, confusion and vagueness provides an unlimited reservoir for hermeneutical endeavors.

He who searches for a champion of the market economy and of liberalism must look elsewhere. But he must look no farther than to Hayek's teacher and mentor: the great and unsurpassed Ludwig von Mises.

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The Philosophical Contributions of Ludwig von Mises

David Gordon*

A central theme unites Ludwig von Mises's frequent ventures into philosophy. Mises believed that economics as he practiced it gave access to "a third class of the laws of nature."[1] The method of economics differed fundamentally from that of physics and biology, the sources of the other classes of natural law. A sound theory of knowledge thus must place proper stress on deductive inquiry into human action, the method of economics. The place of economics in ethical theory is less direct; but here too, the results of economic analysis closely circumscribe the available options in value theory.

In sum, Mises wrote philosophy as an economist. Unlike his great rival John Maynard Keynes, who held philosophical opinions that molded his economic views, for Mises the direction of causation went in the opposite way: economics determined philosophy.[2] I shall endeavor to illustrate Mises's distinctive angle on philosophical questions, concentrating principally on the theory of knowledge and ethics.

The guiding thread in Mises's theory of knowledge was the defense of economics. His discipline needed to be guarded against metaphysical assault and scientific attempts to eliminate the category of human action. In Mises's opinion metaphysical arguments cannot be used to challenge economics, since human beings cannot

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[1]Ludwig von Mises, *Human Action* (New Haven, Conn.: Yale University Press, 1963), p. 885.

[2]I have attempted to show the influence of Keynes's philosophical views on his economics in "Keynes's First Principles," *Dissent on Keynes*, Mark Skousen, ed. (New York: Praeger, 1992), pp. 149–60.

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attain the ultimate truth that metaphysicians seek. "It is beyond the pale of a rational inquiry to enter into an analysis of any variety of metaphysics, to appraise its value or its tenability and to affirm or to reject it."[3] Thus all-embracing schemes, e.g., Hegel's depiction of the growth of the Absolute Idea to full self-consciousness, cannot rightly be used to challenge economics. To claim, with Werner Sombart, that economics rests on a "method of isolation" which correct philosophy has exposed as fallacious is illegitimate.[4] Economics, not metaphysics, sits in the driver's seat.

But why? How does Mises know that metaphysical inquiry is sterile? His argument is the following: In order to survive, human beings identify regularities in the world. Unless one can anticipate that objects will behave in a fixed manner, action is impossible. One can do nothing if the world is, in William James's phrase, "a booming, buzzing confusion." The assumption that objects operate in a regular order, however, cannot be proved. "There is no deductive demonstration possible of the principle of causality and of the ampliative inferences of perfect induction; there is only recourse to the no less indemonstrable statement that there is a strict regularity in the conjunction of all natural phenomena."[5]

The assumption of regularity is not the only principle human beings use to categorize the world, but all other principles depend on it. Thus, if it cannot be proved that the world really is regular, none of the other categories can be deductively derived. From the fact that human beings must think about the world in a certain way, it does not follow that the world really has the attributes we ascribe to it. "In epistemology . . . we are dealing neither with eternity nor with conditions in parts of the universe from which no sign reaches our orbit nor with what may possibly happen in future aeons."[6] It is this limitation of our thought that closes our access to truth about metaphysics.

Like Immanuel Kant, then, Mises thought that the human mind grasped the world only through its own categories. But this similarity hardly suffices to make Mises a strict Kantian. Unlike his great predecessor, Mises did not claim that a particular set of categories is a

[3]Ludwig von Mises, *The Ultimate Foundation of Economic Science* (Princeton, N. J.: D. van Nostrand, 1962), p. vi.

[4]I consider the German historical school in greater detail in *The Philosophical Origins of Austrian Economics* (Auburn, Ala.: Ludwig von Mises Institute, 1993).

[5]Ludwig von Mises, *Theory and History* (New Haven: Yale University Press, 1957), p. 4.

[6]Mises, *Ultimate Foundation*, p. 15.

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necessary presupposition of experience. To Mises, the categories are ones that human beings now in fact use. He essays no transcendental argument in the style of the *Critique of Pure Reason* to derive them.[7] Indeed, as we have seen, he specifically denies that the causal principle can be demonstrated.

Instead of a logical derivation of the categories, Mises offers an evolutionary "just so" story. Human beings who did not use the assumption of regularity would be unable to survive. Their more fortunate relatives who did use this category would by comparison flourish. Through a process analogous to biological selection, a set of common categories gradually became entrenched in the human mind.[8]

At first sight, one might be inclined to object to Mises's evolutionary argument in this way: If people who use the regularity principle survive, while these who do not do so perish, what is the explanation of this fact? Does it not show that the regularity principle is true? If so, how can Mises assert that the principle cannot be proved?

But this objection fails: Mises is entirely right. From the fact that using a principle aids survival, it does not follow that the principle accurately characterizes reality. We do however know that the world has *this* property: those in it who use the principle have an advantage over nonusers. Perhaps the best explanation of the success of our categories is that they accurately describe the world, but this is very far from a proof that they do.[9] Further, as Mises well knew, the entire evolutionary scheme is speculative.[10]

In spite of Mises's claim that the principle of regularity cannot be proved, he places great stress on it. The "strict regularity" that he finds in all natural phenomena leads him to reject indeterminism in quantum mechanics. The Heisenberg uncertainty principle limits our knowledge: it does not show that the law of causality is false for subatomic particles.[11]

[7]For an excellent account of Kant's philosophy, see Paul Guyer, *Kant and the Claims of Knowledge* (Cambridge: Cambridge University Press, 1987). Admittedly, some "psychologistic" interpretations of Kant put him closer to Mises, but the similarity is no greater than that between Mises and, say, Herbert Spencer.

[8]Mises, *Ultimate Foundation*, p. 15.

[9]Peter Lipton, *Inference to the Best Explanation* (London: Routledge, 1991), pp. 172–73, discusses the best explanation argument for realism.

[10]Mises presents his evolutionary account as a "speculation." *Ultimate Foundation*, p. 15. In my view, evolutionary epistemology suffers from debilitating objections. For important criticisms, see Thomas Nagel, *The View from Nowhere* (Oxford: Oxford University Press, 1986) and Ralph Walker, *The Coherence Theory of Truth* (London: Routledge, 1989).

[11]For Mises's rejection of indeterminism in quantum mechanics, see *Theory and History*, pp. 88–89.

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Mises's position appears vulnerable. He thinks that the principle of regularity is an essential category of the human mind; we *must* think in accord with it. But if this is right, should we not consider indeterminacy in nature unthinkable? Even if Mises is right to reject real uncertainty in nature, how does he account for the fact that the opinion he opposes can be genuinely considered? On his view it is absurd on its face. He might respond that, after all, quantum mechanics *is* very counter-intuitive. The paradoxes we encounter in this field illustrate Mises's contention that our categories of thought apply only to the world we know.

But what has all this to do with economics? Mises's account of regularity in nature sets the stage for a contrast. The study of human action does not proceed by inductive generalization from perceived regularities. Instead, its method is deductive and its starting point the concept of action. Through an analysis of this concept, the principles of economics can be deduced. "Action and reason are congeneric and homogeneous; they may even be called two different aspects of the same thing."[12]

Can Mises maintain consistently his contrast between the study of human action and the sciences of natural phenomena? Human beings are part of the natural world: why then do they stand immune from the principle of regularity? Mises believes that "determinism is the epistemological basis of the human search for knowledge."[13] If he is right, has he not undermined his fundamental philosophical goal—the defense of Austrian economics?

Mises's response provides a key to understanding his thought. Determinism *does* apply to human beings: "What a man does at any instant of his life is entirely dependent on his past, that is, on his physiological inheritance as well as of all he went through in his previous days."[14] But we do not know how human thought and action are determined by these factors. Determinism is thus of no use in the study of human action. Instead, we must assume that the mind operates autonomously. To claim this is not to assert that the mind really is independent of the physical world: this contradicts what Mises takes to be a basic assumption of science.

Instead, "[m]ethodological dualism refrains from any proposition concerning essences and metaphysical constructs. It merely takes into account the fact that we do not know how external events . . .

[12]Mises, *Human Action*, p. 39.
[13]Mises, *Theory and History*, p. 74.
[14]Ibid., p. 77.

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affect human thoughts, ideas, and judgments of value."[15] Mises's vindication of praxeology, then, is this: In spite of the principle of regularity, we do not know how human thought is determined. Theories that assign particular causes to thought thus are metaphysical, not scientific, and must be rejected. Two features of this argument require stress. First, in line with his wish to defend economics rather than support a philosophy of his own, Mises assumes as little as possible. He does not assert that human beings are metaphysically free: he contents himself with the claim that in economics they must be treated as rational actors. More questionably, he manifests a strong hostility to metaphysics.

Mises's view of human action provides additional evidence that he is not a strict Kantian. As we have just seen, Mises's position is that human beings must be treated as rational actors, since we do not know how action is determined. Kant's was in part the reverse. He thought that the real or noumenal self is not determined. It is not that we have no access to the laws that determine human action, as Mises believes: we really are free.[16] In the world as we know it, i.e., the phenomenal world, the situation is otherwise. Human action is determined by the desire for happiness.[17]

In this latter view, Kant and Mises are quite close. Mises likewise assumes that "[h]appiness . . . is the only ultimate end."[18] We always aim to achieve the highest ranked of our preferences that we think attainable. Mises does not assume that we can freely choose our preferences: freedom, as he conceives it, is the use of reason to achieve our goals. But this similarity, to my mind, is not sufficient to place Mises in the Kantian camp.[19]

In the theory of knowledge, then, Mises is satisfied with a very modest conclusion: neither physical science nor metaphysics pose a challenge to economics. The limited nature of Mises's claim, however, failed to secure him immunity from attack. The logical positivists (the "Vienna Circle") advanced views that, if accepted, placed praxeology in peril. Mises regarded it as a vital task to reply to positivism, and

[15]Ibid., p. 1.

[16]For an important analysis of Kant's conception of freedom, see "Reason and Autonomy in Grundlegung III" in Onora O'Neill, *Constructions of Reason* (Cambridge: Cambridge University Press, 1989), pp. 51–65.

[17]For the comparison of Mises and Kant, I am indebted to discussion with Ralph Raico.

[18]Mises, *Theory and History*, p. 13. In support of his view, Mises surprisingly cites Ludwig Feuerbach.

[19]The main reason is that in my view Kant does attribute strong free will to the noumenal self.

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I think his efforts in this area constitute his most valuable contribution to the theory of knowledge.

The clash of the positivists with praxeology resulted from their theory of meaning.[20] Briefly put, they held that deduction cannot give us any knowledge about the empirical world. All necessary truths are analytic; they are tautologies that are empirically meaningless. Since praxeology proceeds by deduction from a necessarily true axiom, the threat posed by positivism is apparent. Economics is supposed to apply to the world: it is not "an unearthly ghostdance of bloodless categories." If the method it uses must fail of its purpose, Misesian economics is ruined.

Mises's most important argument against the positivists was a simple one. They purport to banish metaphysics and follow science, but their own position is metaphysical. "[T]he epistemology of positivism is itself based on a definite brand of metaphysics."[21] If positivists accurately took note of praxeology, they would be forced to abandon their views. Praxeology is a deductive discipline that, contrary to positivist dogma, does give us knowledge of the real world. To declare illegitimate an existing science because it violates a philosophical doctrine is itself illegitimate: Metaphysics cannot overturn science.

The force of Mises's point is twofold. First, he himself agrees with the positivists that philosophy is subordinate to science. When he claims that a philosophic doctrine cannot overturn a conclusion of science, he speaks on his own behalf. But, more fundamentally, his argument works against the positivists even if one disagrees with Mises's view about the relation of science to philosophy. The positivists do agree with him here: his argument is thus an effective *ad hominem* retort against them. They, the opponents of metaphysics, are themselves engaged in metaphysics if they reject praxeology.[22]

Mises uses the same response to Karl Popper's falsifiability criterion. Popper, unlike the positivists, did not take all metaphysical statements to be meaningless. He instead adopted the more limited position that all scientific statements must be capable of being proved false. The theorems of praxeology, insofar as they are deductively derived from a self-evident axiom, fail this test: nothing can falsify them.

[20]For a full account of the logical positivists, see J. Alberto Coffa, *The Semantic Tradition from Kant to Carnap: To the Vienna Station* (Cambridge: Cambridge University Press, 1991).

[21]Mises, *Ultimate Foundation*, p. vi.

[22]For a discussion of *ad hominem* arguments in philosophy, see Henry W. Johnstone, Jr., *Validity and Rhetoric in Philosophical Argument* (University Park, Penn.: Dialogue Press, 1978), pp. 5–12.

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Mises's reply is characteristically forthright. If Popper wishes to classify praxeology as unscientific, that is his affair. The proper tests of praxeology are the truth of its axioms and the validity of its arguments. Why should it matter whether praxeology meets the criterion of science proposed by a particular writer? Why does it count against a statement that it is metaphysical in Popper's sense?

Here once more Mises uses an *ad hominem* argument. Like the positivists, Popper contended that definitions do not describe real essences: they are arbitrary proposals for the use of a term.[23] Mises cleverly uses this view against Popper to show that his own characterization of scientific statements is an arbitrary proposal.

Mises has another argument that uses positivist doctrine against itself. "[T]he proposition that there are no synthetic *a priori* propositions is itself a . . . synthetic *a priori* proposition, for it can manifestly not be established by experience."[24] A positivist might deny this and assert that the claim was an inductive generalization. But then what justifies him in rejecting standard examples of a priori propositions, e.g., "whatever is colored is extended," not to mention the theorems of praxeology? Alternatively, a positivist might claim that the disputed statement is analytic, but it is unclear what would ground this assertion.

Mises does not confine his criticism to refutations of the kind just described. He directly examines the main contentions of the logical positivists and finds them wanting. The positivists claim that the propositions of mathematics and logic are tautologies. But even if this is true, we can learn something new from mathematical or logical investigation.[25] Even if all the theorems of geometry are restatements of the axioms used in their proofs, it does not follow that we can at once grasp the theorems when we learn the axioms. The distinction Mises draws here resemble Aquinas's separation of propositions "self-evident in themselves" from those "self-evident to us."[26]

Mises's criticism of the positivists seem eminently well taken; but even if one adheres to that philosophy, Mises has the resources to protect praxeology. He calls the propositions of economics synthetic *a priori* truths, but it is not at all clear that he has in mind what the positivists wish to exclude. What does Mises mean by a

[23]For Popper's "anti-essentialism" see Karl Popper, *The Open Society and Its Enemies*, 2 vols. (New York: Harper, 1967), pp. 9–21.

[24]Mises, *Ultimate Foundation*, p. 5.

[25]Mises, *Human Action*, p. 38.

[26]Aquinas uses this distinction in his criticism of St. Anselm's argument for the existence of God.

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"synthetic" proposition? As discussed above, he replies to the claim that mathematical propositions are tautologies with the point that we can learn something new from some tautologies. Does he mean by a synthetic proposition, then, one that gives us new knowledge? If he does, his position is perfectly consistent with that of his positivist foes. They are concerned to exclude propositions that, in their sense of the terms, are both necessary and non-analytic. So far as I can determine, Mises did not take a position on this issue; he neither asserts nor denies, e.g., that the predicate of the action axiom is "contained" in the subject. He offers no formal account of synthetic propositions, however, so the suggestion that praxeology is immune from positivist attack in this way is conjectural.

Even if this suggestion is rejected, much of praxeology is still under no threat from the positivists. Although "[a]ll the concepts and theorems of praxeology are implied in the concept of human action," its inquiries are restricted "to the study of acting under those conditions and presuppositions which are given in reality."[27] To accomplish this, subsidiary postulates must be added to the axiom of action, e.g., the assumption that labor has negative utility. But "[t]he disutility of labor is not of a categorical and aprioristic character. We can without contradiction think of a world in which labor does not cause uneasiness, and we can depict the state of affairs prevailing in such a world."[28]

If praxeology includes empirical propositions, why would positivists object to it? They do not reject the use of logic in science: they instead think that logic by itself will not provide us with knowledge of the empirical world. But "[e]conomics does not follow the procedure of logic and mathematics. It does not present an integrated system of pure *aprioristic* ratiocination severed from any reference to reality."[29] The only theorems of praxeology, then, that conflict with positivism are those that do not include any empirical propositions in their derivation. Mises has powerfully argued that logical positivism should not be accepted; and, by extending points that Mises makes, we can show that praxeology is in little danger from it.

Of course economists influenced by positivism have followed methods of inquiry radically at variance with Mises's precepts. Many of them place great reliance on empirical testing, while Mises thinks this unnecessary and in many cases not possible. Milton Friedman goes so far as to say that the assumptions of an economic theory may

[27]Mises, *Human Action*, pp. 64–65.
[28]Ibid., p. 65; footnote number omitted.
[29]Ibid., p. 66.

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be false, as long as the theory generates correct predictions. A greater divergence from Mises would be difficult to imagine. But none of these views follows from the verifiability criterion of meaning. A positivist sympathetic to praxeology might take the axiom of action to be a common sense empirical proposition, known by introspection to be true.[30]

One further point requires mention. If praxeology is consistent with positivism, does this invalidate one of Mises's key arguments against the positivists? The very existence of praxeology, he claims, refutes their view of science. But if praxeology is consistent with positivism, must not this argument be withdrawn? As usual, Mises is on safe ground: all that is required is a modification of it. Mises can pose this dilemma to positivist detractors: if praxeology contradicts their views, its existence as a science refutes them; if it does not, they cannot object to it. And in any case, Mises still has intact all his other arguments against the positivists.

Mises's primary aim in epistemology, I have endeavored to show, was to defend economics. "With regard to praxeology the errors of the philosophers are due to their complete ignorance of economics and very often to their shockingly insufficient knowledge of history."[31] In ethics, his main goal was similar but not identical. In his view, economics does not by itself support any ethical conclusions. But if one acknowledges a value judgment that he thinks almost universally acceptable, the establishment of a free market is imperative. Mises recognized that various schools of ethics had objections to the free market, and his aim in this branch of philosophy was to defend the market from attack. His method was a radical one: he denied the possibility of objective ethics altogether. If Mises is correct, all ethical objections to the free market immediately fail.

In Mises's view, it makes sense to ask: given a certain end, how can that end be best achieved? If someone wishes to build a house, the question of how he can best use his resources to do so admits of an objective response. Whether to build the house is up to him; how best to do so is not. Rationality is a matter of means, not ends. The matter is, however, somewhat complicated by the fact that an end can itself be a means to a further end.[32] Mises in fact holds that

[30]These remarks should not be taken as a defense of positivism. In my own view, the verifiability criterion ought to be rejected; further discussion is in my *Philosophical Origins*, pp. 36 ff. Rather, I am here addressing the question: if one did accept the verifiability criterion, how much of Austrian economics could be retained?

[31]Mises, *Human Action*, pp. 32–33; footnote number omitted.

[32]Mises, *Theory and History*, p. 13.

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"[h]appiness in the purely formal sense in which ethical theory applies the term is the only ultimate end." Mises meant by this that we want things not for their own sake but for the satisfaction, assessed purely subjectively, which we expect them to bring us.

Mises's notion of values stands in opposition to two competing types of theory, and he explicitly opposed both. Some philosophers maintain that there are objective goods or ends "out there in the world." Regardless of what people think, certain things just are good or bad. Franz Brentano, a leading advocate of this position, maintained that value judgments were "correct" or "incorrect," analogously to the truth or falsity of factual propositions. Mises rejected Bretano's account; unfortunately he did not discuss Bretano's arguments.[33] Against aesthetic objectivism Mises is scathing: "Only stilted pedants can conceive the idea that there are absolute norms to tell what is beautiful and what is not."[34]

Some proponents of objective ethics agree with Mises that values are not properties that objects possess. Nevertheless, ethics is not subjective, since reason can show that we stand under certain obligations, regardless of the ends we happen to have. Mises has little time for this position. He says of its foremost proponent: the "weakest part of Kant's system is his ethics."[35]

By dismissing objective ethics, Mises has prepared the way for his own defense of the free market. Mises's primary concern to vindicate economics suggests an additional motive for his subjectivist conception of values. Someone who believes in objective values in the style of G. E. Moore but also accepts Austrian economics needs to fit two different kinds of value into his intellectual system. By accepting only subjective values, a drastic intellectual simplification becomes possible; and Mises may have found the temptation to wield Occam's razor too strong to resist. More prosaically, as an economist Mises was thoroughly familiar with subjective values and may have found any other approach conceptually uncomfortable. This in part accounts for the fact that Mises says little to support his condemnation of objective values: he treats the issue as virtually self-evident.

[33]Ibid., p. 36, n. 1. Brentano's views are presented in his *The Origin of Our Knowledge of Right and Wrong*, R. M. Chisholm and Elizabeth Schneewind, trans. (Atlantic Highlands, N. J.: Humanities Press, 1969). An interesting discussion of Brentano on value judgments may be found in Thomas L. Carson, *The Status of Morality* (Dordrecht: D. Reidel, 1984).

[34]Mises, *Theory and History*, p. 63.

[35]Ludwig von Mises, *Socialism* (London: Jonathan Cape, [1936] 1951), p. 430.

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Although Mises does not usually address in detail the arguments of value-objectivists, on one occasion he does so, with illuminating results.

The political philosopher Leo Strauss claimed that many terms in our language fuse descriptive and evaluative components. If, one calls someone cruel, the judgment rests on factual criteria. Stalin acted cruelly, e.g., in bringing about the death of millions of Russian peasants. This judgment is not, to reiterate, a matter of subjective assessment; but is objective in exactly the same way as "Stalin was Lenin's successor." Yet to call someone cruel implies a negative evaluation of him. Thus, contrary to the value subjectivists, language imposes certain value judgments on us. To maintain that all values are subjective is to ignore for a large number of terms the criteria our language establishes.

Mises vigorously dissented. He considered three examples given by Strauss: "cruelty," "prostitute," and "pressure group."[36] In each instance, Mises maintained, one can either use the term in question in a value-neutral way or substitute another term that lacks the value-charged nature of the original. It is thus false that linguistic considerations prevent one from separating fact and value.

This is not the place for an assessment of the dispute. Rather, it is the existence of the dispute itself that merits notice. During the late 1950s and early 1960s one of the most important arguments in modern moral philosophy took place between Philippa Foot and Elizabeth Anscombe, on the one hand, and R. M. Hare, on the other. (All three were at the time teachers of philosophy at Oxford University). Foot and Anscombe adopted precisely the position of Strauss: there are criteria for the use of terms such as "rude" or "courageous." Once a term of this sort is applied, no separate act of evaluation is necessary: the terms are already valuational. Thus descriptive criteria imply an evaluative stance, and the "is-ought dichotomy" is at least in these instances false.

Hare demurred, in terms reminiscent of Mises: "But the primary evaluative words are so classified just because their descriptive meaning is secondary, and is therefore more able to give way when attitudes change, the evaluative meaning remaining unaltered."[37]

[36]Mises, *Theory and History*, pp. 299 ff. Strauss's argument is in his *Natural Right and History* (Chicago: University of Chicago Press, 1953), pp. 50 ff.

[37]R. M. Hare, "Reductio ad Absurdum of Descriptivism" in his *Essays in Ethical Theory* (Oxford: Clarendon Press, 1989), pp. 122. Philippa Foot's side of the argument is in her *Virtures and Vices* (Berkeley and Los Angeles: University of California Press, 1978). For Anscombe, see her "Modern Moral Philosophy" in *Collected Philosophical Papers* (Minneapolis: University of Minnesota Press, 1978), vol. 3, pp. 26–42.

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Like Mises, Hare maintains that no description irrevocably commits us to an evaluation.

In both ethics and epistemology, then, Mises's contributions arise in the course of a defensive campaign on behalf of Austrian economics and the free market. If so, what lessons can be drawn about the way to study Mises's philosophy?

Most fundamentally, his philosophy must be approached through his own writings, taking particular note of the manner in which economic theory suggests to him philosophical positions. The greatest mistake one can make in this area, I venture to suggest, is to assign Mises to a philosophical school and to interpret his economics on that basis. As an example of what must be avoided let us consider the ascription to Mises of a "Bergsonian" view of time. When Mises discusses time in economics, he has in mind time as experienced by human beings, particularly in action. It does not follow from this that Mises should be saddled with either Bergson's criticism of time in physical science as an abstraction or his defense of the intuitive grasp of real duration.

Mises cites Henri Bergson on just a few occasions, and his remarks hardly constitute a ringing endorsement of his views. He agrees with Bergson that for human beings the real present is grasped in action. But he also states: "it is not recollection that conveys to men the categories of change and of time, but the will to improve the conditions of his life."[38] This in context appears to be a criticism of Bergson.

Again, Mises notes: "it is true, as Bergson has seen with unsurpassed clarity, that between reality and the knowledge that science can convey to us there is an unbridgeable gulf. Science cannot grasp life directly . . . . But if one thinks one has thereby pronounced an unfavorable judgment on science, one is mistaken."[39] Mises's conclusion is totally un-Bergsonian. The exact similarities and differences between Mises and Bergson are not our present concern. I have touched on the topic simply for purposes of illustration. Some thinkers are best approached through the careful search for sources and influences. At least in philosophy, Mises is not among them.

[38]Mises, *Human Action*, p. 100. The passage criticizes Edmund Husserl as well as Bergson. I have not discussed the patently absurd claim that Mises was a phenomenologist.

[39]Ludwig von Mises, *Epistemological Problems of Economics* (New York: New York University Press, 1981), p. 46; footnote number omitted.

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The Contributions of W. H. Hutt

John B. Egger*

William Harold Hutt (1899–1988) was a courageous and independent maverick whose work has long been respected by those who work in the Austrian tradition. His scope was broad, encompassing the study of labor and the relationship between government and the economy, but he is probably best known for his monetary economics.

Those who know Hutt's scholarship are likely to consider it "underappreciated," either because his principal work was a criticism of Keynes published at the height of Keynes's influence (Hutt 1963) or specifically because its catallactic, individualistic method was hardly in keeping with the methodological spirit of the 1960s. It is also true, though, that Hutt's writings are difficult to follow and sometimes reflect a utilitarianism that is inconsistent with thoroughgoing subjectivism. Nonetheless, as I hope this survey will indicate, there is much in Hutt's work—particularly his monetary economics—that will delight anyone who is sympathetic to the approach of the Austrian school.

Born in 1899 to a working-class family in London (Seldon 1988), Hutt studied at the London School of Economics and taught from 1928 to 1965 at the University of Cape Town. He then moved to the United States and taught at several universities. From 1972 to 1982 he taught at the University of Dallas, and was an emeritus professor there at the time of his death (Ebeling 1988).[1]

Monetary and labor economics were Hutt's chief interests. His best-known work in monetary theory is *Keynesianism—Retrospect and Prospect* (1963); others in this field include *The Theory*

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[1]For an excellent brief summary of Hutt's life and work, see Salerno (1991).

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of Idle Resources (1939, second edition 1977), *A Rehabilitation of Say's Law* (1974), and *The Keynesian Episode* (a 1979 revision of *Keynesianism*). His rich appreciation of the market as a catallaxy explains his most important contribution: a superior analysis, Austrian in spirit, of money and its relationship to economic activity. Like Marget, Hayek, Hazlitt, and others of his generation, much of Hutt's monetary work was understandably associated with criticism of Keynes.

Hutt's principal work in labor economics is *The Strike-Threat System* (1973), but his first book was *The Theory of Collective Bargaining* (1930, 1980).

Throughout his life Hutt expressed great concern—perhaps reflecting his background—for persons of lower incomes. Their best friend was the market, he told us often; their major enemy was private groups' use of government to plunder them, a concern that led him into extensive work on the political process. Contributions to this literature include *Economists and the Public* (1936)—which one of his scholars and recent colleagues identified as "probably, Hutt's finest work" (Formaini 1989, p. 2)[2] and *Politically Impossible. . .?* (1971). His long-time friend Arthur Seldon wrote: "If Hutt had not been dismayed and distracted by the cul-de-sac of Keynesianism, I think he would have complemented James M. Buchanan and Gordon Tullock and now others in the US and Europe who are developing the fundamental economics of politics, democracy, and bureaucracy."[3]

Professor Hutt[4] knew that his works were not easy to read. He saw that as a regrettable necessity.[5] He respected language and used it with great skill, understanding that it shapes and is shaped by ideas. Although Hutt is often criticized for his use of unique terminology ("Huttite" has been coined to describe it), it was precisely his respect for the power of language, combined with his disapproval of trends that swept economics during his career, that produced his strong sense

[2]Each of us has his own interests and I certainly respect Bob Formaini's judgment, but I consider Hutt's *Keynesianism* books (and *Say's Law*) considerably better and more important.

[3]Seldon 1988, p. 34. See also Hutt's review essay on Buchanan and Tullock's *The Calculus of Concent* (Hutt 1966). Several other essays reprinted in Pejovich and Klingaman (1975) deal with the politics of South Africa. The Pejovich-Klingaman collection also contains the best published bibliography of Hutt's work of which I am aware, though it obviously omits the work of the last decade of his life.

[4]He preferred to be called "Professor," and often corrected those who called him "Doctor." He never received that degree.

[5]"[N]ew definitions are irritating things," he wrote in 1939, "and the mere process of multiplying terms may appear to be both pretentious and barren" (Hutt 1977, p. 45).

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of obligation to resist certain popular economic terminology. A repeated theme is one expressed in *Keynesianism*: "*There are some kinds of language the habitual use of which hinders the perception of certain things as well as the saying of them*" (Hutt 1963, p. ix; italics his). Hutt's terminology places demands on the reader, who must not only follow his new and curious—though usually somewhat self-explanatory—terms (like "contrived incidental plenitude") but must also exercise caution with conventional terms, for sometimes his meaning subtly differs from that of works that now constitute orthodoxy.

Freedom, Government, and the Market

Morgan Reynolds, in his fine "Tribute to W. H. Hutt," insightfully identified William Hutt as a "classical political economist" (Reynolds 1989, p. xii). Hutt himself wrote: "A contemporary trend towards a return of economic science to what could be more appropriately described by the too long disused term 'political economy,' in which the function of vote-gathering is formally treated as an economic factor, may turn out to be one of the most promising developments of this age" (Hutt 1971, p. 23). From the catallactic perspective of Adam Smith and an underlying utilitarianism to his concern with matters of "public choice," Reynolds's term fits. Hutt knew that the individual initiative that liberates us from poverty thrives only under particular kinds of rules, and that these rules may only resemble the legislation that emerges from the political processes of a constitutional democracy. Hutt's lifelong concern for human welfare led him to a study of those processes. He properly considered the likelihood that private groups might wrest control and twist legislation to their own advantage, to be the greatest threat to the human condition.

He wrote courageously about the apartheid policy of his adopted home country, identifying it as a device by which the white unions had seized upon the government as a means to suppress competition from the non-whites.[6] A related and highly regressive policy was "rate for the job" legislation (like our "comparable worth"). Hutt fervently argued that outlawing the ability of the unskilled and inexperienced—or those discriminated against—to acquire the benefits of employment and demonstrate their worth by underbidding other applicants was terribly regressive, unfair, and anti-competitive.

For all of its potential danger, Hutt considered government to have great power to promote well-being, claiming in 1936 that "[w]e may regard the democratic State as the institution that is supposed

[6]See *The Economics of the Colour Bar* (1964). Earlier writings had resulted in the temporary withdrawal of his South African passport (Rothbard 1988, p. 33).

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to interpret and make effective the will of the aggregate of citizens as electors" (Hutt 1936, p. 257). He acknowledged the need for some public welfare, but was convinced that a government enforcing the rules that give maximum range for individual initiative and enterprise permits the market to achieve the most for humanity that can be done, constrained only by "natural scarcities."

Hutt did not explicitly set forth a description of the source and nature of the individual rights that underlie his conception of liberty and government. Indeed, he described in 1930 a belief, so common today, that economics offers a superior alternative: "Economists are all clearly conscious of the desirability of a more equal distribution of wealth; indeed, they base their case for it upon the firm foundation that it will lead to a maximization of economic welfare, and not upon abstractions such as 'natural right' or 'justice'" (Hutt 1980, pp. 73–4).[7] This crude-utilitarian perspective is so prevalent even sixty years later that few economists consider the examination of "natural rights" necessary or advisable. Murray Rothbard, who takes a Lockean approach based on self-ownership, is an outstanding exception (Rothbard 1970, pp. 77–80). Hutt seems to take the utilitarian defense of freedom: it works.

In 1930, for example, he had argued that the economic defense of private property depends on the presumption that "the price determined under private enterprise is the one which best serves the common good" (Hutt 1980, p. 54, n. 29). He also admits (Hutt 1971, p. 46) to having "uncritically accepted" (in 1930) Edwin Cannan's defense of progressive taxation on the basis of diminishing marginal utility. His early thinking, he noted in 1971, "was founded on the fallacious belief that the utilities of income to different persons can be compared" (Hutt 1971, p. 46).

In his 1936 *Economists and the Public*, Hutt expressed most explicitly his sympathy with the utilitarian perspective. His warning of the philosophy's "truly unfortunate effect" (Hutt 1936, p. 300) on economics refers only to the misrepresentation of "economic man" as a short-run hedonist. By this time Hutt seemed to reject the explicit maximization of an aggregative concept of social welfare, explaining that the term "maximizing welfare" is acceptable "if we regard the term as having a purely subjective meaning and do not attempt to extend it to cover any summation of individual welfares into a broader objective unity as 'social welfare'" (Hutt 1936, p. 265, n. 2).

[7]When I cite "Hutt 1980" as evidence for what he said in 1930, I refer to those sections of the second edition of *The Theory of Collective Bargaining* that he left unchanged.

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There is no doubt that utilitarianism can do immense damage when wielded by the untutored. Its "most unfortunate effect" today is the tendency of economists who are infatuated with technique and disdainful of philosophy to back into objective utility and interpersonal comparison without realizing it.

Yet these attractions of crude utilitarianism can be resisted by a strong sense of subjectivism and of the spontaneous coordinating forces of an unhampered market. Prominent economists of the Austrian school have joined Hutt in praise of a more carefully crafted position. Ludwig von Mises (1957, pp. 55, 58) has spoken approvingly of utilitarianism, referring to economics as "its finest product" and calling it a "philosophy of individualism." Much of F. A. Hayek's work reflects a strong utilitarian position. The example of Henry Hazlitt (1972) also shows that a utilitarian foundation can co-exist with a thorough appreciation of the nature of a catallaxy and the rules that it requires. An excellent informal discussion of a utilitarianism that requires and supports individual rights is offered in a 1991 interview with Leland B. Yeager, who notes that he occasionally feels that "Hazlitt has already said everything" (Yeager 1991, p. 6).

"What are the proper limits to the right of association?," John Stuart Mill asked, and in his 1936 book Hutt reported that he "can hardly imagine any problem which is more directly relevant to political economy." He found Mill's advocacy of "freedom to unite for any purpose *not involving harm to others*" to be unsatisfactory because it raised "the rights of combination" above "the free action of individuals" (Hutt 1936, pp. 194–95), and wrote approvingly that Mill's "principle of expediency" justifies "the suppression of economic coercion and private monopoly" (Hutt 1936, p. 196).

In Hutt's perspective, some "combinations" are inconsistent with freedom. He knew that an unhampered market was of great benefit to the relatively disadvantaged. But exactly what activities constitute an "unhampered" market?

To some writers a free market means the absence of legislative violations of individuals' natural rights to life and property. Hutt would duplicate most of their policy advice, say on matters of minimum-wage laws and producer subsidies. But a rights theorist is likely to interpret the formation of a combination as part of the functioning of a free market. Utilitarians make much of the deadweight losses and reductions in consumers' surplus that would result, but these are not consumers' rightful property. Unless government violates rights by enforcing a cartel, its success will probably be temporary. But its existence is fully consistent with a market that, in the natural-rights sense, is free.

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This is not a perspective that would command Hutt's agreement. Combinations like industrial cartels and labor unions, even if unsupported by restrictive legislation, reduce the welfare—relative to a state of open competition—of the ordinary citizen. Throughout his life, Hutt shared the position of Henry Simons and many modern economists that the enforcement of antitrust laws is essential to a market system.

In 1971, for example, he appended to his phrase "provided the appropriate governmental agencies are carrying out their essential role in the functioning of the free market" a footnote explaining that "this role covers primarily the prevention of 'restrictive practices'—or the role of what in the United States is called 'anti-trust'... Emphasis on this role meets the common objection, 'Yes, but markets do not always work'"(Hutt 1971, pp. 95, 99). "If business," Hutt wrote, "including big business, is in any measure responsible for pricing output beyond the reach of income (subject to any degree of inflation) the remedy lies in anti-trust initiatives" (Hutt 1971, p. 78). He referred to resale price maintenance as "one of the most burdensome forms of restrictive practice" (Hutt 1971, p. 86).

Hutt disagreed that "in its complete form [competition] would be ruinous," (1935, p. 184) because he considered "aggressive selling" tactics that he thought might be ruinous (like predatory pricing) not in fact to be competitive. In his view, a legislative structure supporting the market system would outlaw such practices. His terminology (unfortunately) appears to have something in common with modern structure-oriented theorists of industrial organization: Competition could not produce monopoly, it seems, but a system in which the bargains among resource owners were limited only by natural rights could. According to this view—which I believe to be Hutt's—the preservation of the competitive order requires legislation that is not confined by the limitations of individual rights.[8]

The somewhat uneasy (to me, at least) combination of Hutt's powerful understanding of the benevolent forces of the catallaxy and his deep concern for the welfare of the common citizen is seldom more apparent than in his concept of competition. It is "the substitution for consumers' benefit of the least-cost method of producing and marketing any commodity (or of achieving any other objective involving

[8]He addressed some criticisms in 1977: "despite weighty arguments against antitrust which libertarian economists have been advancing in recent years, we adhere to the conclusion that a legal framework to create or protect incentives to substitute lower cost methods or preferred products is a necessary condition for market freedom to exist. This does not imply, however, that antitrust *in its present form* cannot be validly judged as more deleterious than nonintervention" (Hutt 1977, p. 223).

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scarce means), irrespective of the institutional arrangements necessary for the realization of that result" (Hutt 1971, p. 99, n. 4).

It is significant that Hutt defined competition as a process, not as a structure. The modern economist is likely to visualize graphs depicting a perfectly-competitive outcome, a monopolistic outcome (smaller quantity, higher price), and a deadweight-loss triangle. Hutt would identify the entry and imitation by which the monopolistic position is moved toward the perfectly-competitive one as a competitive process. Even the creation of a deadweight loss triangle can be competitive if its cause is an entrepreneur's discovery and implementation of a lower-cost technique. As the competitive process continues, the price will be driven down, eliminating the deadweight loss and transferring surplus from producer to consumer.

Hutt's concept of "consumers' sovereignty," a phrase he originated in 1936, reflects some of the difficulties readers may find with his terminology. It is, to be sure, a healthy antidote to those who write as if producers can inflict their will upon consumers. By exercising their powers of choice, consumers in a market system provide both the incentive and the financing for producers to use resources as the consumers prefer.

Demonstrating the weakness of the substitution of a non-rights utilitarianism for a theory of natural rights, Hutt built his concept on an analogy between the market and government. "Regarded as an ideal," he asserted, "consumers' sovereignty rests on the same assumptions as does the ideal of representative government" (Hutt 1936, p. 262). In a semantic puzzle that reminds one, at times, of Marx, Hutt explained that an individual is sovereign in his role as consumer, and subject in his role as producer. He tells the story of an artist who eschews commercial assignments, at which he could earn incomparably more money, warning that "we cannot refer to producer's freedom as 'producers' sovereignty'. When he ignores society's demands, the producer and consumer aspects of the individual are merged in him. He exercises his sovereignty over the disposal of his own powers and property" (Hutt 1936, p. 263).

It is a perplexing notion, not clarified much by his assurance that he means "'sovereignty' in the sense of 'ultimate power', as opposed to 'source of authority'" (Hutt 1936, pp. 258–59). Hutt's concept of the free market is a society in which consumers' sovereignty is violated by neither government nor private groups. A producer's decision to take a vacation, or to produce a lesser-valued good for his own personal reasons, would be reckoned as his own exercise of his sovereignty as a consumer. His decision to collude with other producers would

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not. The act of collusion is not his own act of consumption, but it does reduce the ability of others to consume.

Although one must develop some facility with "ideal types" in economics—the Kirznerian entrepreneur who neither labors nor owns property, for example—the notion that producers are slaves and only consumers have rights seems a little difficult to keep straight. Every individual plays each role, in Hutt's taxonomy, but his rights adhere only to his role as consumer; in either his role as producer or as resource owner, he is a slave to other consumers. Hutt expressed it this way: "Applying this standard, we must regard property-owners as the custodians of the community's scarce resources. The powers they possess in dealing with these resources must be regarded as delegated to them by society in its consumer aspect" (Hutt 1942, p. 157). The position is not nonsensical, but it appears to me to exemplify precisely the "*kinds of language the habitual use of which hinders the perception of certain things as well as the saying of them*" against which he warned us in 1963. Individuals have rights (or "sovereignty"), and to identify these rights with only one of the individual's many roles is confusing and dangerous.[9]

Hutt's unhampered market would be ruled by "natural scarcity," under which "given consumers' preferences, the sole factor determining the price of consumers' commodities will be the relative amounts of different kinds of productive resources and services available" (Hutt 1936, p. 260). Like many utilitarians, he seems to sidestep the fact that property rights may have something to do with what is "available," and at what terms. But "there are many deliberately created barriers to the most complete utilization of productive power" (Hutt 1936, p. 261), which he called "contrived scarcities." Although he attempted to explain that a producer's "sovereignty over the disposal of his own powers and property" (Hutt 1936, p. 263) could not contrive a scarcity, he identified collusive agreements and other "restrictive practices" like resale price maintenance as contrived scarcities that thwart the principle of consumers' sovereignty. To prevent this "private coercion," the firm enforcement of antitrust statutes was required on the behavior of both business and labor. Then—and only then—would resources be allocated according to "natural scarcities."

[9]The best discussion of "the metaphorical shibboleth of 'consumers' sovereignty'" is in Rothbard (1970, p. 560 *et passim*). On "the community" and "society" as the ultimate owners of scarce resources, see Ayn Rand's discussion of "the tribal premise" (Rand 1965, p. 7).

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A Staunch Opponent—not of Unions, but of the Strike Threat

Hutt is often identified as a critic of unions. But he noted numerous ways in which a union may properly assist the worker in dealing with the employer, maintaining "that a labor union may provide the required knowledge of employment opportunities, supply the expertise and the finance to assist an individual to take advantage of those opportunities, and protect an individual's rights before the law regarding the wage contract as well as facilitate his recourse to the courts when necessary" (Hutt 1973, pp. 12–13).

In fact he opposed only their strike activity. His position was a simple extension of his opposition to private collusion, to the contrivance of scarcity. He fought what he considered to be the private exercise of coercive power, whether by collusion among labor or business. Since government should assure that competition is free to perform its function, economists must oppose this poverty-creating coercion. That means opposing much of government's direct intervention into the economy (e.g., comparable-worth legislation), of course, but it also requires that governments break up private collusion and restrictive practices, eliminating contrived scarcities whether caused by business or unions of laborers.

He believed that the public and policymakers were already convinced of the necessity of addressing business collusion and "restrictive practices." But labor monopoly had long been blessed and/or feared by both the public and the politicians. There can be no doubting Hutt's courage in attacking what he considered to be the most powerful of legalized vandals, who stomp about the country seizing wealth primarily from those who can least afford it—usually with their naive acquiescence.

The Theory of Collective Bargaining (1930) examined the history and theory of two claims: labor's supposed "disadvantage" in bargaining over wages, and the "indeterminateness" of the wage rate. His history notes that unions had been the elite, aloof from and superior to the masses of working men and not caring much about them (see also, Hutt 1973, p. 26). A union's concerted activity raises members' wages only by excluding nonmembers from the particular labor market. Whether this raises or lowers the total wage payment depends on the elasticity of demand for this type of labor—which Hutt noted depends, in turn, on a welter of other elasticities. But the quantity of product will fall and its price rise: "The evil in labor monopolies lies not only in their driving the less fortunate to relatively badly paid occupations but also in their raising the cost of living to them as well"

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(Hutt 1980, p. 13). The principal "exploitation" is through higher prices of consumer goods, and "the greater part of the demand for consumers' goods is exercised by relatively poor people" (Hutt 1980, p. 73).

The belief that unionized labor can exploit capital dies hard. Hutt noted that surely capital can be exploited in the short run. Indeed, there is no more "sitting duck" than a producer who has sunk huge sums into highly specific capital goods. But using an argument like that of "rational expectations," Hutt reasoned in 1930 that "if it were really normal for labor to exploit capital invested in [a particular] class of undertaking, the result would be that less would be invested in this class" (Hutt 1980, p. 62). Investors will look for risk-adjusted returns, and among the risks will be that of the strike. Pre-risk yields on capital invested in different ways will correspond in a direct relationship, and quantities invested in an indirect fashion, to the *ex ante* risk and seriousness of strike. In 1973 he applied the same argument to *human* capital: "The volume of labor which will come forward to be trained for or otherwise become attached to any occupation in which (in the light of past experience) labor appears liable to 'exploitation,' will be reduced to the level at which the prospective long-term benefits are equated with the prospective benefits from training and employment in other occupations" (Hutt 1973, p. 5; all italicized in the original).

Arguing that the "*fear* of strikes inflicts far greater damage on the economic system than actual strikes" (Hutt 1973, p. vii, 1980, p. xviii), Hutt maintained that the result of the political acceptability of the strike is that the strike-threat is an ever-present "contrived" cost of doing business.

The harm that the strike-threat wreaks is often not evident in the unemployment statistics, but results from a pattern of resource use that is not optimal at dealing with "natural scarcity." This problem of "diverted resources" (perhaps better known as disguised unemployment) affects both capital and labor. The existence of this type of unemployment is not obvious, but the welfare of all of us, perhaps especially the poor, is lower than it could be. Hutt's position reflects an appreciation of the Austrian concept of the capital structure and the significance of patterns and types of capital good and labor. Comparing the second and first editions of *The Theory of Collective Bargaining*, Hutt identified as a "major improvement" "the emphasis I now place on the *composition* of the assets stock and the composition of the stock of complementary assimilated knowledge and skills (in reaction to prospective strike-threat depredations" [Hutt 1980, p. xviii]).

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Hutt's analysis of the effects on standards of living of "wage-multiplying assets" and their increasing specificity are superb. His case that the strike-threat reduces welfare, despite the impossibility of quantifying it, is well made. But his conclusion that this warrants outlawing the threat is utilitarian. Without some form of contract, the agreeing among a group of skilled workers to withhold their labor unless paid nearly the whole value of the product violates neither capitalists' nor consumers' rights. A carefully prepared contract can, in principle, reduce the risk of becoming dependent on one employer or employee; without it, the risk is a cost of the increased productivity of specificity.

The enforcement of the antitrust laws is the only major issue on which I—as I believe most other Austrians—disagree with Hutt. To advocate the use of government to prevent actions that violate no rights opens a Pandora's Box.[10] Hutt's heartfelt concern for those of middle and lower incomes may, unfortunately, have made him a victim of "power-thought," an enemy of "rational-thought" of which he warns us in 1936 (Hutt 1936, p. 52 *et passim*).

Money, Macroeconomics, and the Influence of Keynes

Most economists who began their careers around 1930 were profoundly affected by the profession's spectacular embracing of John Maynard Keynes's *General Theory*. Like Hayek, Marget, and Henry Hazlitt, Hutt had read widely and had developed a respect for the monetary economics that had been developed by Hume, Say, Thornton, Wicksell, Mises, and others. "In my judgment," he wrote, "ever since the remarkable contributions of Locke and Hume, monetary theory has been one of the least unsatisfactory branches of economics" (Hutt 1963, p. 87).[11] A brief study of Hutt's interpretation of pre-Keynesian monetary theory will help us to understand his reaction to the *General Theory*.

Pre-Keynesian monetary theory, as Hutt saw it, recognized that the preferences of individuals in an economy are linked by their understanding that the use of money and markets can further their ends. Presupposing that individuals know something about physical reality, markets produce money prices, quantities, and production

[10]As I recall some of our conversations during the mid 1970s, Hutt also supported legislation against libel and slander, largely out of sympathy for the victim. Since one's reputation consists of others' attitudes, it is doubtful that such legislation can find support in natural rights. See Rothbard 1978, pp. 95–96.

[11]The text has "even" rather than "ever," which apparently was a typographical error. It was corrected in Hutt 1979, p. 56.

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techniques that are determined by individuals' preferences for different goods, leisure, time, and liquidity. Anyone who cares to can use these simple money prices to compute relative prices, rates of interest, and a price level. But these constructs are all derivative from particular money prices.

Neither he nor other pre-Keynesian writers considered prices to be "perfectly flexible" (Hutt 1979, p. 77).[12] If that phrase requires traders instantly to identify the equilibria implicit in a new set of preferences, and to reprice just as instantly, it verges on the nonsensical. When a trader is still unconvinced that preferences have turned against him, he may prefer some combination of adjustment in quantity and in price. This quantity adjustment is the conventional explanation of unemployment. Hutt properly identified it as a natural part of the search for information, and called it "pseudo-idleness" (Hutt 1977, p. 83). The combination of changes in price and the disutility of "pseudo-idleness" provides the entrepreneurial incentive and information required for the redirection of resources. Although significant *changes* in either time or liquidity preferences might produce periods of unusually high "pseudo-idleness" (now called frictional or structural unemployment), Hutt repeatedly emphasized that no particular set of preferences —no *level* of time or liquidity preference—was inconsistent with full employment: *"there are no economic ends, and no entrepreneurially chosen means which are incompatible with 'full employment'"* (Hutt 1963, p. 79 [italics Hutt's]; also, pp. 24, 231, and elsewhere).

Hutt respected the gold standard for achieving a stable level of prices, and considered it the obligation of a monetary authority under more "modern" systems to maintain general price stability. Monetary expansion more rapid than the required rate could, of course, affect the market rate of interest and, by falsifying the information provided by the "uninflated" pattern of prices, increase employment and real output. Hutt noted that this had been understood as long ago as Hume; certainly Thornton and Wicksell made much of it. But it had been considered a very poor and costly—socially impoverishing—way of dealing with discoordination in the pattern of prices. Better to address institutional rigidities directly—say, by applying anti-trust legislation vigorously to both business and labor and outlawing the strike-threat.

[12]Hutt used the phrase "perfect price flexibility" as "the absence of money illusion" (Hutt 1979, p. 147), a meaning different from that below.

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Idle Resources and Unemployment

Apart from a few comments quickly inserted into *Economists and the Public* (Hutt 1936, pp. 245–47) as both it and *The General Theory* were in press, Hutt's first direct response to Keynes was in the remarkable *The Theory of Idle Resources* ([1939] 1977).

The work's principal point was that we must be cautious in the conclusions that we draw from the observation that some resource is—or is not—apparently engaged in some kind of productive activity.[13] Hutt reasoned that by examining the *process* that determines whether a machine or person is either "working" or "sitting," one can evaluate the economic function of the activity in which the resource is engaged. Only by exploring the causal process behind the apparent "idleness" or production, he insisted, can one judge whether it is a sign of the market's proper functioning or whether it poses a problem that deliberate government policy might help to resolve.

This is not the place for a full-scale analysis of *Idle Resources*, but a brief description of Hutt's system of classifications of idleness will convey some of its flavor. It reflects those aspects of Hutt's work with which most Austrians would agree, as well as a few with which many would differ.

Although Hutt's first chapter is entitled "Definition of Idleness," and its Section 3 is "The necessity of definition," I can find no clearly stated expression of the meaning of "idleness." The chapter is, instead, a plea for consideration of different causes or types of idleness, and a fine (though brief) argument that it cannot be quantified (Hutt 1977, pp. 49–50). One must *infer* a general meaning from Hutt's detailed classification and from a knowledge of the rest of his works.

A resource is "valueless" if the sum of the *competitive* prices of its complementary inputs exceeds the price of the product. (If the sum exceeds the product price only because the other inputs are "monopolistically" priced, then Hutt would probably classify the resource as "enforced idleness." He was, as we have noted above, a supporter of the general goal of antitrust as applied to both business and labor.) As one might expect, most of the book deals with *valuable* resources.

The important category of "pseudo-idleness" embraces humans who are engaged in job search, education, or "productive consumption," and

[13] Arnold Plant's review noted the importance of the book: "For there is a widespread and growing determination to seek out the idle resources in our economic system and to set them to work; a determination which is surely praiseworthy so long as we recognize idleness when we see it, and in our anxiety to abolish it do not confuse with it many other things which it is even more vital to preserve" (Plant 1940, p. 199).

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physical capital goods that are unused for certain reasons.[14] "Preferred idleness" includes humans who, though excluded from certain occupations by legislation and/or union activity that seeks monopoly rent, elect not to work elsewhere. "Participating idleness" is Hutt's general term for resources that are idle to gain monopoly rent; if they have no value in other employments, they constitute "pure withheld capacity" or (if enforced by legislation and/or union activity) "pure enforced idleness."

In this and later works, Hutt properly assigned great significance to the problem of "diverted resources," normally called "disguised unemployment" when applied to labor. Although these resources appear to be productively engaged, their employment is clearly "suboptimal" if it is the result of some kind of distortion or deviation from a free and competitive system. Hutt discussed, also, "aggressive idleness" (resources held back for the purpose of "predatory pricing"), "strike idleness," and a few other subsidiary classifications.

It is difficult to follow all of the qualifications and interconnections involved in Hutt's system of "at least six" (according to him) or ten (according to me) classifications of "idleness."[15] What is significant about the work is not the disagreement that one might have about Hutt's interpretation of a "free" market (see above, "Freedom, Government, and the Market"), but rather the delightfully insightful analysis of *process* that characterizes *Idle Resources* (particularly with its 1977 addenda).

The ability of unanticipated monetary expansion to reduce some measure of observable unemployment has been acknowledged for centuries. To Hutt, however, its primary effect was to draw resources out of productive "pseudo-idleness" by cutting short the process of search for employment that best satisfied "uninflated" demands. Perhaps acknowledging the popular belief that the word "unemployment" implies some kind of failure or problem, he suggested that we change the way we think about an individual who (in modern terms) is "frictionally" or "structurally" unemployed. His situation has "been mistaken for unemployment," Hutt wrote. "When *actively* searching for work, the situation is that he is really investing in himself by working on his own account without immediate remuneration. He is prospecting" (Hutt 1977, p. 83). Later he explained that he feels "that

[14]Hutt applied this concept of "pseudo-idleness" to cash balances, refuting those who associated the term "idle" with cash balances, in his respected "The Yield from Money Held" (Hutt 1956).

[15]I once prepared a flow chart, with boxes and circles and connecting arrows in the style of a computer programmer's layout, of Hutt's definitional system. It seems to be of some help in keeping the linkages straight (Egger 1980, p. 17).

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the process [of job search] is productive employment rather than 'a productive way in which to use leisure'" (Hutt 1977, p. 126), as it had been described elsewhere.

Even readers who prefer to resist Hutt's implicit advice[16] to redefine frictional and structural unemployment as "employment" can accept his point that—given the perennial change of a dynamic free market and the "imperfections" of information—there is a clear sense in which these resources are, indeed, being used "optimally." Hutt had an abiding confidence in the process of free-market pricing to discover and promote patterns of resource use that best satisfy consumer demands. The power of deliberate policy to bring about this pattern of resource use (human and physical) was limited by the central planner's inability to obtain, and lack of incentive to act upon, the specific knowledge of individual preferences that would emerge from the market process.[17]

What the use of stimulative monetary policy *could* achieve, along with its immediate goal of a reduction in observable measures of unemployment, was "diverted resources"—the channeling of human and physical resources out of the search process and into occupations different from those in which it would have culminated. Warning of this problem, Hutt wrote:

> Superficially, manifestation of the disease in 'sub-optimal employment' seems to be the least harmful form. In reality, we are about to suggest, it is a symptom of the most malignant consequence of impoverishing discoordination. (Hutt 1977, p. 30)

and that:

> But we propose to argue further that the third, relatively *inconspicuous* and *ultimate* manifestation of the disease, namely, the employment of men and assets in sub-optimal activities, is even more detrimental to society; for it mitigates the pains of inflation as well as reduces the conspicuous idleness of human and physical resources. (Hutt 1977, p. 32)

The great detriment of the Keynesian emphasis on aggregate demand, and "employment" (or unemployment) conceived as an aggregate, was

[16]There is a clear possibility, here, of what Leland Yeager has called "the 'Austrian vice'—disposing of substantive issues or reaching ostensibly substantive conclusions by mere verbal maneuvering" (Yeager 1988, p. 209).

[17]"Yet officials not only cannot have the necessary detailed awareness which market signals provide; but most important, they cannot be caused to lose property through error nor be rewarded by the acquisition of property through success" (Hutt 1979, p. 76; italics Hutt).

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its simplistic promotion of policies directed only toward these aggregates. Hutt's point that the "demand" so stimulated[18] was almost certain to "divert resources" from the employments consistent with individuals' real ("uninflated") preferences. His position is consistent with, though broader than, the Austrian theory of the business cycle.[19]

Price Flexibility as Recovery Policy

Hutt never wavered from his principle that the observed unemployment of labor and capital was due to the "mispricing" of particular goods. According to this thoroughly Austrian, pre-Keynesian "classical," Say's Law position, "*[t]he disease is discoordination of the economic system* caused through defects in the administration of the pricing mechanism" (Hutt 1977, p. 29), and the only truly effective remedy was for policymakers to eliminate every institutionalized barrier to price flexibility. Hutt's position is likely to be identified by the "classical" or Austrian scholar as courageous and principled, worthy of admiration and gratitude. No economist who is familiar with the powerful forces against which Hutt stood could suggest that this respect be even partially contingent upon complete agreement with his interpretation of "defects."[20]

The Great Depression of the 1930s posed a severe test to a position like Hutt's. It is interesting to compare his position with the policy advice of the better-known Ludwig Lachmann. Lachmann, while justly respected as one of the great Austrian economists, always perceived considerably more virtue in Keynes than did any other Austrian. Since Hutt shared much with Lachmann and the Austrians, but devoted most of his career to debunking Keynes, a comparison of their stories about the early years of the Great Depression is intriguing.

During the 1920s, Britain's persistently high unemployment had convinced Keynes that the institutionalized sources of nominal-wage rigidity were invincible. He concluded, in opposition to the dominant "Treasury View," that only a forced increase in demand—in the form

[18]I believe he would have called it mere "money-spending power." His Say's Law perspective led him to equate the *demanding* of one real good with the *supplying* of another (though usually, of course, with the intermediary of money).

[19]For a further discussion, substantially in the spirit of Hutt's work, of unemployed resources and the ability of macroeconomic policy to facilitate their use, see Egger (1992).

[20]For my own disagreement, see the discussion of antitrust and the voluntary withholding of labor services in the section on "Freedom, Government, and Market," of this paper. Hutt also considered the monetary authorities' failure to stabilize the level of prices to be a "defect" in most cases; see below.

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of public works projects—could cure the malaise. Keynes's argument, however, left the "classical" *theory* intact. It was to prove the "classical" theory wrong, to prove that capitalism would be plagued by persistent unemployment even if institutional price rigidities were snapped and nominal prices and wages were freely flexible, that Keynes began in the late 1920s to develop the argument of *The General Theory*.

Not everyone was convinced. In a 1977 interview, Ludwig Lachmann recalled:

> two different letters to the *London Times* . . . appeared in October, 1932. . . . In one of them, Keynes and some Cambridge economists who were not, in general, his friends, like Pigou and Dennis Robertson, demanded that the government should take steps against unemployment. And three days later, Hayek, Robbins and Arnold Plant sent another letter saying that anything the government did by way of public works or similar methods would only make things worse and would not have the effect that Keynes claimed it would have. That is to say, the "Austrians" seemed to be committed to a policy of continuous deflation whatever happened. (Lachmann 1977, p. 2)

Arnold Plant had been one of Hutt's professors, and Hutt's later writings—like the 1939 *Idle Resources*—suggest his sympathy with the letter of Hayek, Robbins, and Plant. It is a little tougher, though, to identify Hutt with Lachmann's interpretation about "deflation," because—as we shall see—Hutt believed that, in most cases, monetary policy should stabilize the general level of prices. But he also was convinced that if the British government had acted quickly to break her economy's severe and destabilizing institutionalized price rigidities, no such deflation would have occurred.[21]

Ludwig Lachmann admired much about the Austrian theory of the business cycle (Egger 1986), and his 1956 work (Lachmann 1978) is the most advanced discussion of the Austrian theory of capital that is available. It is likely, however, that he disagreed with Hutt about the ability of free-market repricing to deal satisfactorily with the problems of the early 1930s.

I have been unable to draw a conclusion stronger than this, because Lachmann respected pricing and Hutt advocated (in some

[21]"In my judgment, however, the political obstacles were not insurmountable in Britain in 1931" (Hutt 1979, p. 45, n.17). "*In my judgment* there is not the slightest doubt that, in the absence of 'the sabotage of British industry' which Beatrice Webb (in those words) so deplored in 1931, Britain could have sailed to prosperity under free market discipline and the pre-1914 gold parity" (Hutt 1979, p. 63; italics Hutt's).

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cases) monetary or fiscal stimulus. While Lachmann's recommendation for stimulus in the early '30s is relatively clear, the policy that Hutt recommended is not.

Lachmann adopted Hicks's terms, differentiating between "weak" (consumption-led) booms amenable to Keynesian analysis, and "strong" (investment-led) booms that fit the Austrian mold. He identified the American economy of the 1920s as a "weak" boom (Lachmann 1978, p. 113) and argued that "capital regrouping by itself [as a rule will not] suffice to overcome the situation following the end of a weak boom . . . and there may be much scope for the Keynesian nostrums. No doubt such an underconsumption crisis, due to a flagging 'effective demand' can be at least mitigated by increasing this demand" (Lachmann 1978, p. 119). "[T]here is danger," he wrote further, "that such an underconsumption crisis may degenerate into a cumulative depression. If so, a budget deficit may help" (Lachmann 1978, pp. 125–26). His principal concern, "capital regrouping," was the way in which capital goods were used; since they are reshuffled in response to price changes, I interpret his statement as disputing the efficacy of repricing as a cure for the collapse of a "weak" boom.

Price flexibility fared much better in Lachmann's remedy for the collapse of an investment-led "strong" boom, with which the Austrian theory deals. He recommended, in particular, that no attempt be made to hold the rate of interest down (Lachmann 1978, p. 124). But his *laissez-faire* recommendation was sharply qualified. Correctly noting that "[a]ny sudden and unexpected change in the 'real situation' will probably affect the demand for and the velocity of circulation of money" (Lachmann 1978, 119), Lachmann observed that "where the banks are involved . . . the danger of *secondary deflation* is always present. When that happens the 'recession' which succeeded the strong boom will turn into a 'depression,' a cumulative process of income contraction, as has often happened in the past. Of course it need not happen. But to avert the danger must always be the primary aim of monetary policy in a recession" (Lachmann 1978, p. 120).[22]

According to this analysis, the situation in the United States in the early 1930s would justify both fiscal (as the collapse of a "weak boom") and monetary (as a period of sharp drop in the money supply) stimulus. Lachmann's discussion of recovery policy left the flexibility

[22]A "secondary" deflation is a decrease in the velocity of circulation (an increase in the demand to hold cash balances) that results from speculation that a fall in prices initiated by a "primary" deflation will continue. It is the downward analog of the "flight into real goods." This "secondary inflation," or sharp increase in velocity, is induced by the expectation of a continuing "primary" monetary inflation.

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of prices as an adequate remedy only in the case in which a "strong boom" ended with no attendant collapse of MV.

Other economists who share Lachmann's generally deep respect for the virtues of unhampered pricing agreed that the deflationary early 1930s posed a test that price flexibility could not meet. Nominal price fluctuations work well at providing information and incentive, argued Leijonhufvud (1973), but only if they are sufficiently small that prices remain within a "corridor" within which confidence in effective demand is not shaken, and that was not the case in the early '30s. In a recent apparent attempt both to explain the appeal of Keynesianism and rebut the "*laissez-faire*" (and Austrian) theory, Tyler Cowen (1989) based his case on quantitative historical data consisting of broad aggregates and averages.[23]

Professor Hutt discussed the "secondary depression" or "secondary deflation," like Lachmann's, but he also described a "purposeless deflation." I have not been able to discern clearly the relationship between these two categories of deflation. "Purposeless" identifies "deflation which is not a deliberately chosen means to an end, such as rectifying injustices in the distribution of income, or a determination to fulfill contractual convertibility obligations" (Hutt 1979, p. 229; 1963, pp. 125–26). Among those deflations that were not "purposeless," he used the apparent synonyms "corrective" (Hutt 1979, p. 70) and "rectifying" (Hutt 1979, p. 229, n. 24) to identify the collapse of an inflationary "cheap-money" boom. This was the bust or crash of Austrian and pre-Keynesian works, and it was "purposeful" in the sense of serving the clear, socially advantageous economic function of shaking out the distortions imposed by the preceding inflation.

A "purposeless deflation" offered no such advantages, and in fact imposed distortions of its own, and Hutt warranted that in "rare circumstances . . . credit expansion may be justified":

> In the purely imaginary case in which an expansion of MV merely reverses a former *purposeless deflation*, it may *restore prices* in the

[23]I am not sure what Cowen's goal was. One can accept his piece as a partial explanation for the popularity of Keynesianism. Cowen has a thorough knowledge of Austrian literature and understanding of its method. It is difficult, therefore, to believe that he had even the slightest intention that his comment might serve as a refutation of the theory of the *laissez-faire* remedy. Gene Smiley (1991) offered an extended critique of Cowen's argument, and in his rejoinder Cowen (1991, p. 115) noted that his "original essay was (deliberately) ambiguous on whether free-market economics had not explained the Depression satisfactorily or whether free-market economics *could* not explain the Depression." Since the second subsumes the first, Cowen believes *at least* that "free-market economics" has not yet "explained the Depression."

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> industries which did not withhold capacity and *restore outputs* in industries which did withhold capacity. (Hutt 1979, p. 229)

He further claimed that "I cannot think of any non-Keynesian economist who would deny the possibility that there have been times in which deflations have been misconceived or ill-advised" (Hutt 1979, p. 229).

Hutt admitted of the possibility of "secondary deflation," but maintained that "as we have seen, speculative demand for money . . . arises when current costs or prices are higher than anticipated costs or prices, while *the speculation assists correctly discerned policy*" (Hutt 1979, p. 277). He argued that the need for a "secondary" deflation arises only from "*the unstable rigidities*" (Hutt 1979, p. 277) that interfere with the smooth repricing process. "If speculative demand for money accompanies the downward adjustment of wage rates and it is not offset by credit expansion, a rectifying deflation must be in progress" (Hutt 1979, pp. 277–78).

Was the 25 per cent drop in the M1 money supply of the United States, between 1929 and 1932, responsible for what Hutt called a "purposeless" deflation? Did it constitute a wild overshoot, going far beyond the corrective, rectifying process to inflict positive damage of its own?

Lachmann, Marget, and many others believed so.[24] As for Hutt, most of his discussions focus on the British rather than the American economy during the early 1930s, but he did concede that "[t]here are several non-Keynesian economists (notably Milton Friedman and Clark Warburton) who interpret the United States deflation of 1930 to 1933 in this light" (Hutt 1979, p. 229; also, p. 204). That was not much of a concession, and he may not have agreed.

In his *Keynesianism*, Hutt maintained:

> What "sound finance" *did* do in the pre-Keynesian era was to create every incentive to reprice services and products the sale of which was being held up, as well as to create a strong social motive to eradicate practices which reduced the flow of uninflated income. In the private sphere, the pressures were fairly successful, and had it not been for contrary action by the State, they could, I believe, have rescued the [British] economy—without inflation—from the great depression. (Hutt 1963, p. 42)[25]

[24]Marget was one of the twenty-four signatories of the "Harris Lecture Telegram," in January 1932, urging President Hoover to adopt a number of easier-money policies. Others were Irving Fisher, Lloyd Mints, and Henry Simons. The Austrian economist Gottfried Haberler, who delivered one of the Harris lectures, was not among those who signed the telegram. See Wright (1932).

[25]This wording is repeated with "British" and capitalized "Great Depression"—in Hutt 1979, pp. 124–25.

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After noting, a bit later, that the Macmillan Report identified the great depression as "monetary" in nature "because monetary policy had failed to solve the problems caused by 'a conjunction of highly intractable nonmonetary phenomena'" (Hutt 1963, p. 80; 1979, p. 166), Hutt pointedly asked, in italics: "*But why should monetary policy be expected to solve such problems?*" He noted that "[w]e are abusing any monetary system if we try to use it to rectify nonmonetary discoordination" (Hutt 1963, p. 80).

This was a theme that remained strong in his writings throughout his career. Monetary policy (which, as Hutt used the phrase, included fiscal policy; he correctly saw no substantive difference[26]) is ill-suited as a remedy for an incorrect, discoordinated, pattern of relative prices, yet it is just such a pattern that particularly characterizes a depression. There is *never* such a problem as "insufficient aggregate demand," Hutt argued, so "stimulating it" is always the wrong answer.

Critics of a repricing policy—e.g., Cowen, cited above—associate it with "deflation," but a general reduction of prices and wages has *never* been the point.[27] "[P]re-Keynesian policy did *not* rely on changes in 'the general level' of money wages and prices," Hutt wrote (Hutt 1979, p. 159). The issue, for him and for most Austrian economists, has been a rearrangement of particular money wages and prices, changes in the structure of relative wages and prices. It is hardly coincidence, of course, that in a period of widespread unemployment most of the adjustments of nominal prices and wages happen to be downward.

[26]"It is important to explain that the term 'monetary policy,' as I use it, embraces 'fiscal policy'; for virtually the only difference between the two is that the latter has a certain political advantage—it puts what Keynesians sometimes call 'newly created money' (that is, an addition to the number of money units) initially into the hands of government instead of into the hands of . . . individual borrowers" (Hutt 1979, p. 184).

[27]See, for example, Hayek's observations in Shenoy (1972, pp. 109–10). Discussing one of the most entrenched cases of nominal rigidity, Britain of the 1920s, Hayek concluded:

> No doubt the situation then meant that full employment required that some real wages, perhaps those of many groups of workers, would have to be reduced from the position to which they had been raised by deflation. But nobody can say whether this would necessarily have meant a fall in the general level of *all* real wages. The adjustment of the structure of industry to the new condition adjustments in wages would have induced might have made this unnecessary. But, unfortunately, the *fashionable* macroeconomic emphasis on the *average* level of wages prevented this possibility from being seriously considered at the time.

Shenoy does not clearly date Hayek's comments but identifies them as from the draft of a lecture ("Competition as a Discovery Procedure") delivered in 1968 and later reprinted in Hayek (1978).

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But the downward slide of *levels* or *averages* is incidental to the Austrian adjustment, not the essence of it. The only defense of a falling level of nominal prices that accompanies the reshuffling of relative prices is that there is no way to *prevent* such a decline without interfering with the process of the efficient restructuring of relative prices and wages.

Despite the many respects in which Hutt's perspective may appeal to Austrians, for a couple of reasons one must be a bit cautious before categorizing him.[28]

The first reason is that his concept of a "free market" (and, therefore, *laissez faire*) not only permitted but *required* government action against collusion (of both business and labor). If it were clear that the pattern of prices obtaining on the eve of a depression was the result of the exercise of such "private coercion," Hutt had no qualms about using the force of government to help to break the initial rigidities. "[O]ne thing *is* clear," he wrote. "There has never been a case for a government *to overrule* the market. Yet there is a case for the collective overruling of a privately contrived overruling!" (Hutt 1979, pp. 175, 176).

In his 1979 revision of *Keynesianism*, he specifically addressed the question "What do *you* recommend should be done about the restoration of 'general activity' in a depression" (Hutt 1979, p. 167)? His 10-page discussion may puzzle and dismay those who seek to identify him with *laissez faire* in its natural-rights sense, since it describes a "Special Authority" (Hutt 1979, pp. 171–72) with—among other things—the power to force wage reductions in industries where it is apparent that prior collective bargaining had driven them above market-clearing levels. (The reductions would stop when the affected industries reported that further reductions would not permit them to retain their workers.)

The critical reader must recognize that, to Hutt, the snapping of collusively established prices is hardly different from, say, the removal of a government-enforced price support on an agricultural commodity or of a rent ceiling. Furthermore, the practical success of collusive "withheld capacity" and above-competitive prices, over a number of years, usually *does* require the intervention of legislation that violates individuals' rights. Hutt did not insist that we accept his specific method of resolving this problem. But the reader should

[28]I note (without further comment) that there is disagreement, among economists usually identified with the Austrian school, about the nature of a proper monetary system—the dominant contenders are of a gold (or other commodity) standard, and "free banking."

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be somewhat discomforted if he is inclined both to be harshly critical of Hutt and to believe that voluntary collusion doesn't work.

A second reason for caution about categorizing Hutt is his advocacy of the policy goal of a stable level of prices. He apparently became more convinced of the desirability of this goal between his 1963 *Keynesianism* and its 1979 revision, *The Keynesian Episode*; a page-by-page comparison often shows the insertion of new paragraphs emphasizing the stability of "M_r", "the aggregate value of money in 'real terms'" (Hutt 1979, p. 191), which seems to be simply M/P (or its quantity-equation equivalent, T/V).[29] He advocated a gold standard (e.g., Hutt 1979, p. 172), but as long as an institution like the Federal Reserve System continues to exist he believed that its mandate should be general price stability. "[I]f the value of the money unit *is* to be maintained at a *defined and constant value*," he wrote, "monetary policy will *have* to be flexible and the nominal money supply must rise in proportion to the flow of services" (Hutt 1979, p. 174).

Despite all of his emphasis on the snapping of institutionalized price rigidities and the abilities of competitive repricing to achieve coordination, Hutt was most distressed at *Keynesianism* reviewer David McCord Wright's characterization of him:

> Where I failed most seriously, however, was in leaving my critic with the impression that I am "a hard-shell, sound money, and price-flexibility man *who would never increase M or certainly not MV*" (my italics). Wright did perceive that some of my "qualifications" conflicted with any such judgment. But a large part of what I was trying to communicate was *exactly the opposite*—to show that, whereas in Keynes's equations M was a constant, I regarded it as a policy variable. (Hutt 1979, p.17)

Bringing this policy goal to bear on the question of the "secondary deflation," Hutt noted that market-clearing repricing is associated with deflation only "on the assumption that the increase in real income is confronted with monetary rigidity. But why *should* we always assume monetary rigidity" (Hutt 1979, p. 275)? He argued that when monetary policy either consciously aims at, or simply passively permits, a general rise or fall in the level of prices, "*the whole price system is immediately thrown out of coordination*" (Hutt

[29]"[In *Keynesianism*] I regarded it [M, the nominal money supply] as a policy variable. I hope that the changes that I have made to parallel passages in the present text demonstrate this beyond all possible doubt" (Hutt 1979, p. 17).

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1979, p. 278). Although a deflationary repricing process will eventually shuffle things around at a lower level of prices, he found that to be "crude and wasteful":

> It is really superfluous, I feel, to have given as much attention as I have to so crude and wasteful a method of curbing secondary inflation [*sic*: deflation]; for a rectifying credit expansion is always possible. There is never any good reason why central banks cannot control the magnitude M so that MV is in constant relation to T. (Hutt 1979, p. 278)

The Austrian theory of the business cycle, with which Hutt was thoroughly familiar, provides a reason (and maybe a "good" one): it is impossible to increase M without affecting relative prices, a process that necessarily interferes with the market's efficient rearrangement of them. (Austrian business-cycle theory is built on the assumption that monetary policy is conducted in such a way that the particular relative prices whose work is systematically thwarted are those involving the rate of interest.) Hutt was not an enthusiastic supporter of the Austrian theory of the business cycle, although he appreciated its general approach.[30]

Evidently he believed that monetary policy could be conducted to minimize its effect on relative prices, while preventing the "crude and wasteful" process of price deflation by stabilizing the general level of prices. The benefits for long-range planning of a stable level of prices may have more than offset, to Hutt, any incidental and essentially random effects that a properly conducted monetary policy would have on relative prices.

So what are we to make of Hutt's stand on "secondary deflation," price flexibility, and monetary policy? What are the differences (once we get beneath the anti-Keynesian vs. Keynesian terminology) between his position and Lachmann's? As even those who deeply respect his work have come to expect, he does not make the drawing of a clear conclusion easy.

First and foremost, Hutt explicitly stated his conviction that a sufficiently courageous government could have snapped the "unstable price rigidities" for which (in Britain, at least) coercive union

[30]See Hutt (1936, p. 372) and (1979, pp. 148–49) for some comments. Considering the scope of this work, there is very little about the Austrian theory of the business cycle. He took a Wicksellian approach (or, more accurately, one of the several distinct Wicksellian approaches) to the "natural rate," identifying it with that rate of interest that corresponded to a stable general level of prices. If an increase or decrease in productivity produces a fall or rise in the price level, Hutt argues, unless there is a change in M "market interest . . . will diverge from the natural level" (Hutt 1979, p. 197).

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activity was largely responsible, and that if this action had been taken no significant decline in the general level of prices would have occurred.[31] His analysis of Say's Law explains that a move toward equilibrium of the price in one industry increases the output (and, probably, employment) in that industry. This, in turn, stimulates the demands—in a natural and healthy way—for other ("noncompeting") goods, reducing the size and ameliorating the effects of the price adjustments necessary in their markets. Sufficiently early and vigorous repricing in just a couple of major industries might well have clipped off any general deflationary pressures.

Second, however, is Hutt's evident conviction that once a "secondary deflation" (at least one that is "purposeless") has begun, it is the foremost task of the monetary authority to stop this "crude and wasteful" process with a "rectifying credit expansion." Such advice seems to place him in the company of many, including Lachmann, whose dictum that avoiding secondary deflation "must always be the primary aim of monetary policy in a recession" (Lachmann 1978, p. 120) could just as well have come from the pen of Hutt. Like the Austrians, he identified its cause as the distortions produced by a preceding inflation, and he appears to have allowed for ("purposeful") "corrective" deflations (some of which might even be "secondary") that he would not offset with monetary stimulus (Hutt 1979, pp. 277–78). But when a deflation was "purposeless," the humane prescription was a "rectifying" monetary expansion.

Third, although he emphasized "price coordination" and wrote as if "purposeless deflation" was very rare, his clearly and frequently stated monetary goal of general price stability stirs up the issue a little more. Hutt is properly respected for his work on the coordinating effect of the repricing of particular goods; this position is much less radical if a stable price level is being taken for granted.

In summary of this section, I think the general reputation of Professor Hutt as a courageous advocate of price flexibility is correct and dominating, and it is largely that which will *and should* appeal to Austrian economists. But it misstates Hutt's position (and he would not appreciate that) to infer that in an economy confronting a sharp rise in the demand for cash balances, he would place the whole burden of adjustment on individual repricing decisions. He shared with others the belief that resource allocation through repricing worked best in an environment of a stable price level.

[31]See Hutt (1979, pp. 63, 64, 272–73).

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A Few Observations on Keynes

Today we can only imagine the shock and dismay that monetary scholars like Hutt and Marget experienced at the popularity of the *General Theory*. Hutt wrote, "Keynes's confidence, eloquence and reputation—not his reasoning, which at first left me bewildered—dealt the hardest blow to my own intellectual confidence which it has ever received" (Hutt 1963, p. 4).[32] He worked hard on the *General Theory*, but found it so fraught with confusion and error that he hardly knew where to start. "Where he was right," Hutt concluded, "he was not original, and . . . where he was original he was wrong" (Hutt 1963, p. 11).[33]

Like most interpreters of the *General Theory*, Hutt identified the key element as the assumption of price rigidity. (Although Keynes discussed nominal rigidity, his great effort was to demonstrate that capitalism would be plagued by rigid relative prices even if nominal prices were perfectly flexible (Egger 1989, pp. 446, 448–50).) Surely, if something keeps relative prices from changing then only a specific pattern of preferences will be consistent with full employment, and a set of preferences (e.g., for time or liquidity) that is inconsistent with these rigid relative prices will produce lasting unemployment. The government can either force the expression of preferences that are consistent with the rigid prices (through the taxation and spending that constitute fiscal policy) or render the price rigidities ineffective by the deliberate distortions resulting from inflationary monetary policy.

Hutt's conclusion about the principal message of the *General Theory*, hidden among new terminology about multipliers and things, was that the effects of discoordinations caused by price rigidities could be concealed by increasing the supply of, or reducing the demand for, money. Hutt considered these insights to be among the oldest in monetary theory, but the whole of the Keynesian system seemed to be a contorted defense of their use.

The various spending "multipliers" functioned, Hutt demonstrated, only if they were accompanied by reduced demand for, or

[32]The impact on the well-read Marget of Keynes's brash dismissal of virtually all of his scholarly predecessors is evident in the Prefaces to the two volumes of Marget's *The Theory of Prices* (1938, 1942).

[33]Hutt noted that Henry Hazlitt wrote, about the same time, that "I could not find in it a single important doctrine that was both true and original." This judgment was not unique to Hutt and Hazlitt. Colander (1981, p. 7) attributed this—without further citation—to Frank Knight: "Keynes said some things that were new and some things that were true. Unfortunately the things that were new weren't true and the things that were true weren't new."

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increased supply of, money. His brilliant chapter "The Acceleration Fallacy" (Hutt 1963, pp. 289–339) showed that the "accelerator" rests on a stock-flow confusion and an arbitrary specification of time period.[34]

But the fundamental confusions in Keynes's thinking, culminating in his false denial of Say's Law, were deep and conceptual. The modern student, imbued with the concepts of Keynes-inspired macroeconomics, will find it almost impossible to follow Hutt here. The Austrians—with their subjectivist, disaggregated approach and concern about "essentials"—are best equipped to appreciate Hutt's work.

Consumption, for example, is "the extermination of value (Say's definition)" (Hutt 1974, p. 13) and usually involves exchanging an asset for services (say, eating a can of beans). In no sense is it spending money, which is an exchange of one asset for another (buying another can). One generates income not by spending money but by creating productive services. These involve disutility, so they will be created (supplied) only for the purpose of demanding something whose value exceeds the disutility. It is not a matter of "supply creating demand" or vice versa; one can't do one without the other.

Some of the services might be consumed immediately by their creator (scratching one's chin), but the rest—unconsumed income—is at least temporarily *saved*. One cannot save *in general*, without those savings taking some specific form. Choosing that form is *investing*, the exchange of services for assets.

Rather than examine in detail Hutt's (1974) "rehabilitation of Say's Law," let us consider its principal effect on the typical undergraduate presentation of Keynesian macroeconomics.

If saving without investing is impossible, the whole Keynesian objection to Say's Law evaporates. The typical Keynesian story relies on different individuals doing the saving and investing, with some of them deciding to save while the others decide not to invest. I recall Hutt's exclamation, "How hopelessly wrong it all is!"[35]

The role of the rate of interest is a vital point on which Keynes was thoroughly confused. Hutt joined other "natural rate" writers in identifying it with individuals' time preferences. An individual would save, in the sense of increasing the relatively permanent level of his

[34]This chapter was dropped in the 1979 revision, because "the phenomenon plays so unimportant a role in Keynes's own theoretical system" (Hutt 1979, p. 7). Hutt's argument provided the inspiration for Peterson (1956), Rothbard (1970, pp. 759–64), and others.

[35]Hutt used this phrase occasionally; it appears, following a misinterpretation (by an American Keynesian) of Say's Law, in Hutt (1979, p. 154).

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assets, only if he perceived the rate of return on available assets to exceed his own time preference. If nobody offered to borrow at a rate above his own time preference, and no asset that he could purchase himself (including additions to his own money balances) offered an implicit return in excess of it either, he simply would not increase his stock of assets. His preferred alternative would be to exchange his income services, through the intermediary of money, for assets (like the beans) whose services he would consume relatively quickly.

"There is *always* a 'demand for savings.' There are *always* 'investment outlets' or 'investment opportunities,'" Hutt wrote (Hutt 1963, p. 240), and it is probably his single most telling point against the general Keynesian system. There is no downsloping IS curve relating the rate of interest to the amount of output and employment. The rate of interest affects not the size but the composition of output, the time pattern of achievable future consumption, according to individuals' preferences.

Hutt pointed out that Keynes was able to develop an upsloping LM curve—a set of (interest rate, income) pairs at which the demand for and supply of money were equated—only because he confused liquidity and time preferences.[36] "He claimed that the determinants of the rate of interest are the supply of and demand for money (liquidity). Now, the intelligent tyro in economics jumps quite naturally to this kind of conclusion, which Keynes obviously thought he could make the keystone of his system" (Hutt 1963, p. 29).[37]

One of Hutt's best known arguments is that "the demand for money is not . . . a function of the absolute level of the rate of interest" (Hutt 1963, p. 106). A market rate of interest is implicit in the relationship between the price of assets and that of their services. A pure rise in time preference requires that the prices of assets fall and of their services rise. A pure rise in liquidity preference will reduce both asset and service prices, leaving their relationship unaltered.

Of Keynes's "opportunity cost" argument, Hutt maintained: "The extent to which people will sacrifice *pecuniary* interest in order to hold money is completely uninfluenced by the absolute level [of the rate of interest]; for a similar sacrifice has to be made in order to acquire or retain all other assets" (Hutt 1963, p. 106). This is—in part—a denial of the Keynesian dichotomization between the decision to save, and the decision to hold that savings in a particular form

[36]"[C]ertain mercantilist, Keynes-like, fallacies . . . such things as the confusion of saving-preference with liquidity-preference" (Hutt 1974, p. 7).

[37]In 1979, Keynes's position became that of "the intelligent novice" (Hutt 1979, p. 111).

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(bonds or money): while the dichotomizing Keynesian naturally interprets explicit monetary interest as a cost of holding money, Hutt reminds us that it is really the cost of holding *anything except* bonds. Keynes's "speculative" reason for holding cash balances was more acceptable to Hutt, but was just an example of a combination of transaction costs and uncertainty about future prices—which itself was likely to have had monetary causes and, in any case, bears no necessary relation to the current level of interest.

All that was left of the Keynesian insights, after deleting these errors, was the thoroughly pre-Keynesian conclusion that a market system whose coordinating forces are hobbled by rigid prices would likely not employ resources fully, but that some obvious effects of those rigidities could be eliminated by monetary policy.

Late in Hutt's life, he was excited that others—particularly Clower, Leijonhufvud, and Yeager—seemed to express views that were importantly like his. The term "unemployment equilibrium" faded, to be replaced by the more satisfactory "unemployment disequilibrium." The problem became not that income services were not demanded, but that they were neither supplied nor demanded because of discoordinations in the pattern of relative prices. These advances seemed like an affirmation not only of his work, but of the pre-Keynesian monetary tradition he had striven so hard to uphold.

Conclusions

We feel that we understand another when his points seem consistent with our prior beliefs. The great difficulty that Hutt faced was that the concepts comprising the macroeconomic superstructure, in which—by now—so many have so much invested, are difficult to integrate with an understanding of how a money-using catallaxy functions. He believed that he had to go beneath them, to some kind of foundation on which we could all agree, and then construct almost a "parallel universe," a new (which he always insisted was old) conceptual structure adequate to the task.

His exposition is considerably less unfamiliar to those already well acquainted with the subjectivist analysis of catallactic processes. William Hutt was driven by his understanding that the market excels at producing and equitably distributing wealth. Economists could help, or at least not get in the way, only if they understood the functioning of a monetary catallaxy. Developing and conveying that understanding was Hutt's life work, and in it there is much of value that the well-read Austrian cannot afford to miss.

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Note

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A Note On Jean-Baptiste Say and Carl Menger Regarding Value

Kenneth K. Sanders*

In this journal, an enlightening article appeared by Joseph T. Salerno (1988) concerning the neglect of the French liberal school in Anglo-American economics. The purpose of the present note is to reinforce a point contained therein. That point is: "The tradition [Smith-Say type approach to value theory] culminated in the work of F. B. W. Hermann who, starting from basic concepts formulated by Say, developed an approach to price theory 'emphasizing consumers' desires and incomes,' which came to serve later 'as the starting point of Menger's utility analysis'" (1988, p. 123).

Offered below, as evidence of an intellectual kinship on value between Say and Menger, is a citation from each. The quotation by Say is an excerpt from a letter that he wrote to Charles Robert Prinsep, the English translator of Say's *Treatise on Political Economy*. The letter is dated 1821.

> The costs of production are not the foundation of price; the foundation is found uniquely in the need that men experience for making use of the product. They consent to pay for making use of the product. They consent to pay the pains (the toils) or the price that the product costs, only by reason of the utility that it has. If this utility is great enough in order that the consumer consents to place on it the price which it costs, one makes it or else one acquires it from those who have made it; if its utility does not appear sufficient in order to be worth this expense, one does not create it, or one does not buy it if someone has had the folly of making it. I have need of a piece of cloth of a certain quality; this need determines me to employ 20 shillings for it; if its costs of production, or what you call *difficulty of attainment*, do not permit that one produce it at less than 25 shillings, I do not want it

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> any more; I would serve myself of another cloth; the difficulty which accompanies the possession of the first does not contribute to raise the price; it is not then a necessary *element* of its value, and when you reproach me in twenty places of not having expressed it thus, you reproach me of not having sustained a doctrine essentially false. What seems to me incontestable is only that the utility of things is the cause of the price that we place on them; but that this price would not be known to fall below the costs of production. When we present a vase under a fountain, it is not the rim of the vase which holds the water of which it is filled, but it is the rim of the vase which prevents the liquid from falling below a certain height. (Say 1833, pp. 144–46)

Similar sentiments were expressed by Menger in his *Principles of Economics* in 1871.

> The value an economizing individual attributes to a good is equal to the importance of the particular satisfaction that depends on his command of the good. There is no necessary and direct connection between the value of a good and whether, or in what quantities, labor and other goods of higher order were applied to its production. A non-economic good (a quantity of timber in a virgin forest, for example) does not attain value for men if large quantities of labor or other economic goods were applied to its production. Whether a diamond was found accidentally or was obtained from a diamond pit with the employment of a thousand days of labor is completely irrelevant for its value. In general, no one in practical life asks for the history of the origin of a good in estimating its value, but considers solely the services that the good will render him and which he would have to forgo if he did not have it at his command. Goods on which much labor has been expended often have no value, while others, on which little or no labor was expended, have a very high value. Goods on which much labor was expended and others on which little or no labor was expended are often of equal value to economizing men. The quantities of labor or of other means of production applied to its production cannot, therefore, be the determining factor in the value of a good. Comparison of the value of a good with the value of the means of production employed in its production does, of course, show whether and to what extent its production, an act of *past* human activity, was appropriate or economic. But the quantities of goods employed in the production of a good have neither a necessary nor a directly determining influence on its value. (Menger 1976, pp. 146–47)

In ending, a warning (and a plea) must be extended to Austrian economists—there is a danger, not of complete neglect of the French

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liberal school, but of a lack of full use by Austrian economists of that tradition (Say in particular). Say presented a "mutual interdependence analysis of market processes" (Salerno 1988, p. 120) which is crystallized in his own Law of Markets. A *complete* understanding of Say's own Law of Markets, which is based on exchange and subjective value, would be of great theoretical and practical value to the Austrian school of economics. A reading is recommended of Say's *Cours Complet d'Économie Politique Pratique* (1828–1833). Also see Sanders (1990).

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Book Review

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The Harvard Plan for Drugs
A Review of *Against Excess: Drug Policy for Results*. By Mark A. R. Kleiman. New York: Basic Books, 1992.

As the casualties from the war on drugs mount, the appeal for moderation in the title of Mark Kleiman's latest book on drug policy is most welcome. However, make no mistake about it, *this is no case for legalization*. Rather, the author makes a case for a technocratic solution to our drug-abuse and drug-policy problems. As the most recent and sophisticated defense of prohibition, it is worthwhile reading for everyone interested in drug policy. In view of the victory of the Clinton regime, *Against Excess* could serve as the blueprint of future drug policy.

This is the latest version of what I call the Harvard approach to drug policy—a hodge-podge of policies and programs designed to "rationalize" drug policy and to professionalize drug war management. While it has been said that Harvard hates America, I have found this simply not true. Harvard profits from America. What Harvard (not Kleiman) hates is that Americans still remember and still have some attachment to the Jeffersonian concept of self-government. It is this attachment and this concept that gets in Harvard's way of controlling and profiting from Americans through more government power and greater control over the individual's daily life. Not only is Kleiman's case for the drug war based on the lack of self government, his recommendations would create employment opportunities for yet another army of drug policy and law enforcement experts.

The basic Harvard argument on drug policy goes as follows: America is a liberal society; the liberal society relies on the self-government of individuals; drugs are different from other consumer goods in that drugs undermine the ability of drug takers to self govern and often create external harm for people who don't take drugs; therefore we need a special policy for drugs.

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However, not only are drugs different from other consumer goods but drugs differ from one another with respect to their effects and the harm that can occur from their abuse. As a result, the Harvard approach requires that each drug or group of drugs have a specially designed policy in order to minimize the costs of both drug abuse and drug policy.

Kleiman proposes, or rather endorses, the neo-prohibition of alcohol and tobacco that is sweeping this nation. Higher taxes, more regulations and restrictions, infringements on the right to free speech (advertising), and more government is the answer here. The benefits of alcohol, although widespread and well established by nearly a century of research and thousands of years of experience, are treated by Kleiman with skepticism—as if the latest research on the health benefits of alcohol was actually the first!

He accepts the neo-prohibitionist Gospel that the problems of fetal alcohol syndrome and second-hand smoke are highly significant when in the first case it has been blown out of proportion and in the second case it has yet to be scientifically verified. No doubt this proposal will be like sweet music (or fine red wine) to the army of bureaucrats, government researchers, and agencies that have been created and prospered from neo-prohibitionism.

Kleiman proposes to decriminalize marijuana. Marijuana would be highly taxed and regulated like alcohol and tobacco. This is the lone bone he throws to the supporters of legalization and will no doubt get some positive reception at *High Times* and N.O.R.M.L. I can sympathize with the author's insistence that public policy towards dangerous drugs convey a warning to consumers, but frankly the average purchaser of beer, wine, spirits, cigarettes, and freon knows that the average politician is collecting excessive excise taxes not out of concern for the consumers' health or environment, but out of concern for tax revenue. Nevertheless, this is a worthwhile section and I would also recommend Kleinmen's 1989 book on this subject, *Marijuana: Costs of Abuse, Costs of Control* (Westport, Conn.: Greenwood Press).

The author would continue the prohibition of narcotics, although attention would be shifted away from arrests and towards "inconveniencing" black-market participants. Drug-involved offenders would get free drug treatment and would be drug tested when on bail, probation, or parole. He also wants more government methadone maintenance, education, tighter controls on prescription drugs and federal control over treatment facilities. The clincher in Kleiman's program *against excess* is his recommendation for adding $20 billion to the war on drugs—a tripling of resources! Therefore, while Kleiman

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is preaching for moderation in drug policy he is actually promoting a massive shift in resources, power, and rights away from the people to the central government. In his recent address to the Drug Policy Foundation, Nobel Laureate economist Milton Friedman warned us that the war on drugs was really a war against people by the government and that government is the problem. This important issue is completely neglected by Kleiman.

The conclusions and proposals in this book are based on the author's understanding of the perfectly rational consumer, an economic model that allows some economists to translate human action (however imperfectly) into mathematics. For Kleiman, it is this nearly perfect, rational consumer that is the prerequisite of the classical liberal society. The application of this model is both inappropriate and incorrect. First of all, the classical liberal society is not based on the methods of liberal welfare economists or on the presumption that all citizens are "rational" in all respects. Rather, it is based on the ideas of people who fought for freedom and the documents that represent their legacy such as the Magna Carta, the Declaration of Independence, the Articles of Confederation, and the Bill of Rights.

Second, the author does not fully understand the workings or limitations of the model. He notes that to have rational time preferences requires an individual to apply the same rate of discount to all decisions. His example of an irrational individual is one who is willing to lend money to a bank at an interest rate of 8 percent while at the same time borrowing money from the credit card company at an interest rate of 20 percent. Here he fails to realize that people also have liquidity preferences (the preference for cash on hand) as well as time preferences. An individual's liquidity preference will outweigh time preference under certain conditions, resulting in this very type of "irrational" action. The fact that individuals have limited information and have many different types of preferences (time, liquidity, leisure, risk, sex, etc.) makes it difficult, if not impossible, to describe any action as irrational in the typical economic sense.

One of my favorite pieces of "evidence" that Kleiman uses to support his contention that habit and addiction are stronger than the rational individual comes from a study based on personal interviews. A certain percentage of individuals regret having started various habits or for not quitting those habits. This evidence is pure after-the-factism (*post hoc* reasoning). Naturally, people will "regret" actions where most or all of the benefits have been received, but the costs have yet to be paid. Eating hot and spicy food, having unsafe sex, and buying on credit are just like smoking cigarettes or getting drunk—you get the benefits immediately, but you incur future costs.

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It is human nature that we are willing (at the time of choice) to pay more later to get benefits now. If we are truly worried about time preferences and short time horizons, then the war on drugs is no answer. Prohibition destroys individual responsibility towards drugs and it is individual responsibility and maturity that instill a future orientation where drug abuse and other risky activities are avoided.

Kleiman has several remaining issues that undermine the viability of his policy recommendations. He is apparently worried that the costs drug abusers inflict on others would be greater under legalization, yet he seems unwilling to make users pay the costs themselves. In fact, he would offer *free* drug treatment and rehabilitation to all takers. (One might even suspect that the odds are good that Mr. Kleiman also supports some form of national health care system that would increase the "free rider" and "moral hazard" problems, thereby contributing to the irresponsible use of drugs.) He also bases his support for prohibition on the fact that the criminal justice system does not do a good enough job of preventing drug-related crime. Most informed observers, however, trace many of the problems in our criminal justice system to the burden and corruption placed on it by narcotics prohibition. Finally, I would note that even Mr. Kleiman realizes that only a small percentage of the population develops abuse problems with any specific drug and that we do not know what makes a given person have an abuse problem with a given drug. Why then does he recommend a nationwide policy that is oppressive, impersonal, and ineffective?

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